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MONETARY POLICY AND THE DEFENCE OF THE CANADIAN DOLLAR

Remarks of
Louis Rasminsky, Governor of the Bank of Canada,
before a joint meeting of The Canadian Club of Victoria
and The Federated Council of Sales Finance Companies,
Victoria, October 17th, 1968

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Mr. Chairman, I have a number of reasons for being particularly happy to be with you in Victoria today. Having already made a speech in one of our island extremities, Newfoundland, early in the year I am pleased to be at the other, on Vancouver Island, as the year begins to draw to a close. I wonder whether this entitles me to say that I have been seen and heard, in the words of the Canadian Coat of Arms, "a mari usque ad mare" during the course of the year.

This is by no means my first visit to British Columbia but it is my first time in Victoria, and this, of course, is another source of gratification to me. Being a newcomer I shall steer clear of any attempt to make sage comments on local matters and shall content myself by saying what is evident to my tourist's eye, that Victoria, as befits the capital, is keeping up with the development of Canada's most dynamic province. It is highly gratifying that the pace of growth in British Columbia has not slackened. Spectacular development and dramatic achievements are, of course, nothing new in British Columbia's history. But what impresses me most is that the intermittent and irregular growth of earlier years, which in a pioneer community was necessarily based to a considerable

degree on speculative enthusiasm and acts of faith, has been replaced by steady and persistent development resulting from a great expansion in your markets in the Pacific regions, particularly Japan, in the states to the south of you, and to your prairie neighbours as well as in the rest of Canada. British Columbia must have gained enormously in internal strength and in the ability to promote self-generating growth by the doubling of its population that has taken place since the war. The province has also, of course, benefitted greatly from technology, a factor which was brought home to me when I reflected that crossing the mountains by air did not take many more minutes than the number of days it took Alexander Mackenzie in his epic crossing to tidewater in 1793.

My visit to this beautiful capital city comes at a time when the Federated Council of Sales Finance Companies is holding its annual meeting here and I also greet the members of this group. I am looking forward to an exchange of views with representatives of the sales finance industry this afternoon.

My final reason for being glad to be able to accept your invitation to be here today is that it gives me an opportunity to report on the way in which the Bank of Canada has been carrying out its responsibilities this year.

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moment when the pressure on the Canadian dollar that developed last winter was still very severe. The turning point in the defence of our currency, which was in serious danger, had not yet been reached, and this was therefore not the most convenient date on which to end the story, but it is the latest date on which the law permits me to submit my report. That particular episode, I am glad to say, has had a happy ending. Now that it is possible to breathe easier - and I can assure you that we passed through some anxious moments - I would like, in these remarks, to take time to look back on that period and explain the role played by the Bank of Canada in helping to defend the exchange value of the Canadian dollar. Some explanation is appropriate since the defence, although very much worthwhile, was by no means easy or without cost for the Canadian economy. As part of the defence it was necessary for Canadians to experience the highest level of interest rates in our history. However, we succeeded in avoiding the serious inflationary developments and the economic dislocation that would have resulted from a failure to protect our exchange rate. Moreover, apart from our own great interest in defending our currency, a failure on Canada's part might well, in the uneasy conditions of the time, have had serious repercussions on the whole international monetary system.

The exchange problem of last winter was above all a crisis in confidence. This has been demonstrated with unusual clarity by the information which has become available since our period of greatest

difficulty. It is now evident that the balance of our international trade in goods and services was strong throughout the whole period, stronger than it had been for many years, and much stronger than was generally realized at the time.

Let me remind you very quickly of the trend of our international accounts. In 1965 and again in 1966 we had a current account deficit of over $1.1 billion, that is, our imports of goods and services exceeded our exports of goods and services by this amount. The financing of these deficits naturally required substantial net inflows of capital to cover them. A marked improvement in our foreign exchange earnings was expected in 1967 because of the large tourist receipts which would be generated by Expo and other centennial attractions. This expectation was in fact fully realized. Indeed there were some additional favourable factors and the deficit was cut by half - to $550 million. But this improvement was expected to be temporary. With the ending of the flow of special tourist receipts in the autumn of the year it was widely anticipated that we would revert to something approaching the large deficit positions of 1965 and 1966. This time the general expectation proved to be wrong; our merchandise exports were strong through the fourth quarter of 1967 and have continued to be strong so far this year, with the result that even with the return to more normal tourist income our current account balance has improved. Unfortunately, owing to the unavoidable lags in

gathering information, the full strength of this underlying position was not generally known during the period when the Canadian dollar was under pressure.

Although the major causes of the weakening of confidence in the Canadian dollar last winter were of external origin, they were superimposed on a domestic situation which in some respects was not reassuring. We had been going through a period of substantial rise in prices and costs and there was concern about the effect which these developments might ultimately have on our international competitive position if they persisted. Taking the whole period since say 1960, our record with regard to costs and prices looked relatively good by comparison with other countries, but in 1966 and 1967 costs had been rising more rapidly than those of most of our major trading partners, including the United States. Indeed, by the autumn of last year we seemed to have developed an inflation psychology in this country. I tried to draw attention to this problem in a speech in Winnipeg last November. At that time I expressed the view that it was essential to break inflationary expectations by making it clear beyond doubt that inflation would not be accepted as a way of life in Canada and that this was the most urgent task of public policy. I am still strongly of this view, and my conviction is not lessened by the fact that Canada has been fortunate enough in recent months to have experienced a very strong international demand for many of its principal exports, or by the evidence

that the deterioration in our cost and price structure has not gone so far as to undermine our international competitive position.

The worsening of our cost and price position does appear to have weakened our capacity to withstand the shocks from abroad that we have had to face. The first of these came on November 18th when sterling was devalued. The devaluation of one of the world's two major reserve currencies was bound to cause strains in the international financial system, particularly when the United States, the country which provides the other major reserve currency, was also experiencing balance of payments difficulties. It immediately raised the question of how other currencies would fare. It was remembered that in the 1930s, and again in 1949, when the exchange value of sterling declined this was followed by some drop in the value of the Canadian dollar. The fact that the proportion of Canadian trade which would be directly affected by the devaluation of sterling in 1967 was very much smaller than on earlier occasions was perhaps not so widely recognized. In any case, in a situation where there is concern about the international financial system I am afraid that it is inevitable that any country which, like Canada, has to depend heavily on inflows of capital appears to many to be in an exposed position.

At the time of the devaluation of sterling the Bank of England raised its Bank Rate from $6\frac{1}{2}$ per cent to 8 per cent and the Federal Reserve Banks in the United States raised their rediscount rates from 4 per cent to

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$4\frac{1}{2}$ per cent. The Bank of Canada reacted immediately by raising its Rate from 5 per cent to 6 per cent and market rates of interest soon moved up. Continued concern about the stability of the international financial system gave rise to heavy purchases of gold by private speculators, the first of a number of "gold rushes" which were to come in the next few months. In this connection, as a measure of international co-operation, the Bank of Canada in December requested Canadian banks and other financial intermediaries not to extend credit on gold nor to facilitate forward purchases of gold.

The Canadian dollar appeared to withstand the first disturbance reasonably well. In late November its exchange value declined from its upper limit but this development had been generally expected because of the ending of the special tourist receipts connected with Expo and for seasonal reasons. However, what turned out to be the second major shock was not long in coming. On January 1st the United States announced a new and much stiffer programme to control capital outflows and strengthen its balance of payments position. It was clear that in designing this programme, efforts had been made to minimize its difficulties for Canada but nevertheless one of its immediate effects was to raise questions about the basic viability of our position, dependent as we have been on large imports of capital from the United States to finance our current account deficit. More generally, the new programme gave rise to concern as to how the world was going to accommodate itself

to the prospect of quick and substantial improvements in both the American and British balance of payments positions.

This combination of circumstances led to weakening of confidence in the Canadian dollar in January. One of the first indications was an unusual degree of hedging of Canadian dollar positions, including the sale of Canadian dollars forward for quite long periods. The forward discount on the Canadian dollar deepened sharply and the spot rate fell. There were indications that some subsidiaries of foreign companies were among the earliest to be involved in these hedging operations on a large scale. Once confidence was shaken there was danger that residents and non-residents alike would take steps to protect themselves against the possibility of a change in the exchange rate.

A number of measures were taken promptly to help restore confidence and restrict speculation. On January 21st the Bank of Canada announced that following discussions with the chartered banks it had been agreed that the banks should discourage the use of bank credit to facilitate abnormal transfers of funds abroad by Canadian subsidiaries of foreign companies or to meet requirements in Canada which had in the past normally been met by parent companies. At the same time the Bank Rate was raised from 6 per cent to 7 per cent and in the subsequent period the Bank of Canada pursued a policy that put upward pressure on market interest rates. The purpose was to increase the incentives for investors to keep their funds

in Canada and for borrowers to bring funds into Canada. Also on January 21st, following discussions between Canadian and United States authorities, the U.S. Treasury Department released a statement making it clear that the new U.S. programme was not intended to produce abnormal transfers of funds from Canada to the United States and that the programme left room for large flows of capital to Canada. To offset a rapid decline in Canada's reserves of gold and U.S. dollars in January the Bank of Canada drew U.S. $250 million of its U.S. $750 million reciprocal credit facility with the Federal Reserve System.

While these measures helped the situation they did not correct it. Pressure on the Canadian dollar continued through February and into March. Uncertainty developed about Canada's fiscal position and concern about the international financial system, reflected in a large increase in gold purchases in free markets, continued to grow in this period.

At the end of February Canada drew U.S. $426 million from the International Monetary Fund. Of this amount only U.S. $185 million involved a repayment obligation and the balance represented Canada's creditor position with the Fund. In early March, when Euro-dollar interest rates began to move up again, it seemed desirable to supplement reliance on interest rate policy with more direct measures to reduce the outflow of capital. Accordingly, the Bank of Canada asked

the banks and other financial intermediaries not to facilitate the outflow of funds through certain foreign currency deposit transactions and this request was widened by the Minister of Finance with an appeal which included all investors. I am glad to be able to say that a high degree of co-operation was forthcoming.

Weakness in the Canadian dollar continued, however, and our situation became grave. It became clear that confidence could not be restored without a fundamental improvement in the conditions of our access to foreign capital. Such a change - and it was an important and dramatic one - occurred on March 7th when it was announced that following discussions between Canadian and United States authorities, the United States had undertaken to exempt Canada completely from all U.S. balance of payments measures affecting capital flows that were being administered by the Department of Commerce or the Federal Reserve System. For our part, Canada stated its intention to take any steps necessary to ensure that the exemption from the U.S. programme would not result in Canada's being used as a "pass-through" by which the purpose of their balance of payments programme would be frustrated. Guidelines to banks, non-bank financial institutions and non-financial corporations have since been issued to help fulfil this commitment. The Canadian Government has also agreed to invest a substantial proportion of its U.S. dollar reserves in special non-market obligations of the U.S. government. Such investments have the effect of reducing the U.S. balance

of payments liquidity deficit as measured by the U.S. government while at the same time the funds continue to be available to Canada in case of need.

On the same date, March 7th, additional standby credits to supplement Canada's depleted foreign exchange reserves were arranged by the Bank of Canada in the amount of U.S. $150 million with the Deutsche Bundesbank, U.S. $150 million with the Banca d'Italia and U.S. $100 million with the Bank for International Settlements. The Export-Import Bank of the United States opened a standby credit for the Government of Canada in the amount of $500 million. These standby credits were in addition to the $500 million still available to the Bank of Canada under our reciprocal arrangement with the Federal Reserve System and the large credits which were still available to Canada from the International Monetary Fund.

Developments also took place within Canada around this time which helped to restore confidence. It became clear that a tax increase would be passed by Parliament and the Government indicated that it was considering new policies in regard to prices and incomes.

The exchange tide finally turned in March, and the turn was assisted by the announcement on March 17th that the Gold Pool countries had taken steps to halt the drain on their gold reserves and to establish a two-price system for gold. The Bank of Canada immediately announced that it would co-operate with the central banks of the Gold

Pool countries. At the same time our Bank Rate was raised to $7\frac{1}{2}$ per cent following an increase of $\frac{1}{2}$ per cent in the rediscount rate of the Federal Reserve System. Finally, the reciprocal credit facility with the Federal Reserve System was increased to $1 billion, including the $250 million which had been drawn.

From that time on the outlook for world currency stability improved and our foreign exchange reserves rose steadily. The coincidence in timing is further evidence of the link between our problem and the general concern about the stability of the international monetary system.

Confidence was further strengthened by the announcement on March 30th, following the meeting of Ministers and central bank governors of the Group of Ten at Stockholm, that plans to strengthen the whole international financial system by establishing a scheme for special drawing rights in the International Monetary Fund would be proceeded with. By April 19th, when the Federal Reserve Banks increased their rediscount rates by a further $\frac{1}{2}$ per cent, our situation had improved to the point where it was not considered necessary to raise the Bank Rate here.

After the Bank Rate had reached its peak of $7\frac{1}{2}$ per cent, market interest rates continued to rise, partly as a result of upward movements in the United States. During the spring months both Government of Canada treasury bill and long-term bond yields reached peaks of around 7 per cent, with mid-term yields even higher. Other bond yields

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rose to high levels and mortgage rates reached the 9-9½ per cent range. This period of very high interest rates was necessary to attract funds from abroad to rebuild our foreign exchange reserves. To encourage confidence in the Canadian dollar, to hasten the rebuilding of reserves and to shorten the period during which such high interest rate levels would be required, Government bond issues equivalent in total to U.S. $262 million were sold in Germany, Italy and the United States in May and June.

Continued improvement in our foreign exchange reserves permitted us to begin dismantling the extraordinary defences for the Canadian dollar in June. Short-term interest rates declined in the market. The special guideline on foreign currency deposits issued in March was cancelled about mid-June. The Bank Rate was reduced from 7½ per cent to 7 per cent on July 2nd, to 6½ per cent on July 29th, and to 6 per cent on September 3rd. One half of the U.S. $250 million drawing on the Federal Reserve arrangement was repaid at the end of June and the remainder late in July. The special credit facilities arranged by the Bank of Canada with the central banks of Germany and Italy and with the Bank for International Settlements had been terminated by the end of July. No drawings had been made under them, but I believe that these credit facilities made a valuable contribution to the restoration of confidence in the Canadian dollar, and I have already publicly expressed the Bank of Canada's gratitude to the institutions concerned for their timely help. The reciprocal

credit facility with the Federal Reserve System remains in force, with the full amount of $1 billion available in case of need. On September 13th the Government announced that it had discharged in full its obligation to the International Monetary Fund and that the standby credit from the Export-Import Bank had been terminated. The Bank of Canada has withdrawn the request made to the banks in January regarding loans to subsidiaries of foreign companies. Market interest rates have come down significantly from the peaks reached this spring though, as in the United States, they remain considerably higher than they were twelve months ago, and in both countries they have risen somewhat in recent weeks.

I have recounted this story in some detail mainly to show why and how monetary policy was used to help defend the Canadian dollar over a period of seven months. As our external position improved, along with international financial conditions generally, it became possible to follow a policy that allowed interest rates to decline during the summer months. This decline in interest rates was accompanied by a relatively large expansion in the total assets of the banking system and in the total of currency and bank deposits, often referred to as the "money supply". If one were to look only at the rate of expansion of these particular magnitudes, it would appear that the Bank of Canada was following an aggressively easy monetary policy this summer, but I do not feel that this was the case. As I have explained on a number of occasions, the Bank of Canada does not regard changes in the "money

supply" as the sole or even the chief criterion of its policy. The central bank's policy is directed towards the whole range of credit conditions. This involves an assessment not only of the availability of credit, including the rate of expansion of the banking system and of various classes of bank deposits and many other factors, but also of the cost of credit, including the general level of interest rates. Interest rates are still high by any historical standard.

Perhaps I should mention here that there have been a number of special factors affecting the rate of expansion of the banking system since the Bank Act was revised a year and a half ago. For many years before, the banks operated under certain competitive disadvantages and they grew at a slower rate than other financial intermediaries. With these competitive disadvantages removed the banks have been regaining some of the lost ground. This relative shift back to the banking system has meant that banking statistics taken by themselves have given an exaggerated impression of the increase in the liquidity of the economy. In addition, increasingly keen competition between financial intermediaries, including banks, has I believe tended to increase the proportion of the public's financial claims which it holds with financial intermediaries rather than in the form of direct holdings of securities. For example, there are now new types of bank deposit instruments with yields that are more attractive in relation to yields on securities than used to be the case.

A particularly striking example of this was seen in the summer months when many holders of Canada Savings Bonds cashed their bonds and acquired deposits with banks and other institutions. While this development led to an increase in the rate of expansion of the banking system it did not alter the volume of liquid assets held by the public. A new series of Canada Savings Bonds is now available on very competitive terms and it seems likely that some reversal of this shift may take place.

All financial institutions have been affected in one way or another by the changes that have occurred in the competitive situation during the past few years. Some of them have had to go through a difficult period of consolidation and in some cases, retrenchment. Some groups have had more difficult adjustments to make than others. The sales finance companies, who are at present meeting in Victoria, not only have had to cope with changed competitive relationships resulting from revisions to financial legislation but they have been among those most affected by United States balance of payments guidelines and, of course, they were affected by the unfortunate troubles of one firm in their industry three years ago. The exemption of Canada from the U.S. balance of payments programme last spring has removed one of their handicaps. The industry has been tackling its problems in a constructive way and it has also done much to improve the confidence of investors by increasing substantially the information that its members make available. It has been experiencing renewed growth this year.

Now that the problems connected with maintaining a sound external financial position have eased it is possible to concentrate once again on our other economic problems. I am afraid that none of them has gone away. Prices and costs are still rising too rapidly despite the emergence of considerable unemployment and unused capacity. The growth of the economy has been well within our potential for more than two years but so long as the strong upward trend in prices and costs continues, there are real risks in taking steps to accelerate the expansion of total spending in the economy. Our recent trade performance has demonstrated that Canada is still competitive internationally but it is also true that our recent exchange problems have shown how important it is to avoid any undermining of confidence by a further extended period of poor cost and price performance.

It is plain that in addition to following sound fiscal and monetary policies we need to do everything we can to increase the efficiency of the economy and to bring about more realistic attitudes toward the size of the increases in the incomes, all forms of income, which we can really afford to pay ourselves. There has been a good deal of discussion in recent times about guidelines for increases in incomes and other aspects of incomes policy and I have made it clear that I favour action in this area. I am not going into that matter further today except to say that the basic limit for the non-inflationary increase in incomes in any economy is not set by the

authorities. It is set by our actual performance. The basic limit is the increase in real output per person employed. If we ignore that limit and settle for larger increases in money incomes all we are doing is guaranteeing that prices will rise.

I have devoted most of my time today to the story of how we came through some rather dark days last winter. Not only was our own currency under pressure but the whole international financial system seemed at times to be in jeopardy. In this area the skies are brighter now. I have recently returned from the annual meeting of the International Monetary Fund where I was encouraged by the evidence of much greater international financial stability and by the progress which is being made toward improving arrangements for international liquidity. We seem to have in prospect a further opportunity to pursue our economic objectives in a relatively favourable international environment. Let us try through exercising reasonable restraint, to make the most of our opportunity.

REMARKS OF LOUIS RASMINSKY
GOVERNOR OF THE BANK OF CANADA
AT THE BUSINESS OUTLOOK CONFERENCE OF THE
NATIONAL INDUSTRIAL CONFERENCE BOARD
TORONTO, OCTOBER 23RD, 1969

Remarks of Louis Rasminsky, Governor of the Bank of Canada, at the Business Outlook Conference of the National Industrial Conference Board, Toronto, October 23rd, 1969

I am pleased to have the opportunity to address this luncheon meeting of the National Industrial Conference Board. In the middle of a day which you are devoting mainly to an intensive discussion of the current economic situation and our economic prospects, I am glad to have a chance to tell you something of the way monetary policy has been developing in this country and something about the problems of dealing with inflation, as seen from the point of view of the central bank.

For about a year now the immediate objective of monetary policy has been to help to bring about and maintain tight credit conditions. From the autumn of 1968 until the spring of 1969 the impact of Bank of Canada operations on the banking system took the form of a substantial reduction in the liquid assets of the banks and a progressive reduction in the rate of expansion of their total assets. By May 1969 the more liquid assets of the banks, which provide the cushion which enables them to expand their lending activity, had been reduced by three-quarters of a billion dollars; and the ratio of their more liquid assets to their total assets had fallen from $32\frac{1}{2}$ per cent to 28 per cent, a level which is very low by historical standards. A further $250 million of bank liquidity was immobilized last April when the Bank of Canada used its power to increase

the secondary reserve requirements of the banks. Beginning in the autumn of 1968, the cost of credit in financial markets and institutions rose sharply and the availability of funds in the domestic bond market was greatly reduced.

By the spring of this year the level of liquidity of the banks as a group had declined to the point where they felt obliged to take steps to reduce the rate of increase in their loans. Since there are always large unused loan commitments outstanding at any time, this process took a while to have its full effect on the trend of bank loans outstanding. By July the impact of changes in lending policies became clearly evident. The banks' general loans, which include both business loans and personal loans, continued to rise very strongly in the first four months of the year, rose less rapidly in May and June and did not rise at all from June to September. Thus by the early summer, potential borrowers were finding that credit, besides being very costly, was becoming much more difficult to obtain.

The central bank's management of the cash reserves since then has continued to constrain the over-all liquid position of the chartered banks. Their more liquid assets declined sharply in July and have remained approximately level since then.

I need hardly tell this audience that credit conditions in Canada have become very tight. The increase in the money supply, using any definition you choose, has been negligible in recent months. Defined as

public holdings of currency and Canadian dollar bank deposits, there has been no increase in the money supply since February, and the increase amounts to less than 6 per cent over the past twelve months. Bank credit is hard to come by. In spite of the sharp reduction in the demands of the Government of Canada on the capital market this year, other borrowers have not been able to raise as much money in the domestic bond market. Interest rates are very high. They range from about $7\frac{5}{8}$ per cent on 3-month treasury bills to 10-$10\frac{1}{2}$ per cent on first class conventional mortgages. Since the rise in interest rates is a world-wide phenomenon there has been little room for escape from high interest costs by borrowing abroad, although funds may be somewhat more readily available for some borrowers outside Canada than at home.

I do not believe that one can explain either the insistence of lenders on receiving such high interest rates or the willingness of borrowers to pay them, without reference to the strong expectations of continued inflation that have developed. Borrowers have been reluctant to postpone expenditures for fear of incurring higher costs later, and lenders have sought to protect themselves against the impact of rising prices by refusing to lend except at high rates. Inflationary expectations have unhappily become a central feature in our economic situation, and it is a central task of economic policy to try to eliminate the causes of these expectations.

I mentioned a moment ago that there had been a considerable shift in the Government of Canada's fiscal position. In the twelve months ending September 1968, the Government's over-all cash requirements, excluding those of the Exchange Fund, were $1,200 million. In the twelve months ending September 1969 there was a net cash availability of nearly $100 million. This large swing has been of great assistance to the central bank in controlling bank liquidity during the past year. Had it been necessary to deal with a large increase in public debt at a time when monetary policy was directed towards reducing the liquid assets of the banking system, it is obvious that the increase in interest rates would have had to be even greater than it was, or the growth of the money supply would have had to be larger.

That is as much as I want to say today about the way in which monetary policy has been developing, and I turn now to a few brief comments on the current economic situation. As background, I want to say something about how financial policies of restraint should be expected to have their effect. Anti-inflationary monetary and fiscal policies operate by restraining the rate of increase in total spending in the economy. I suppose that in an ideal world a moderately lower rate of increase in the dollar value of spending would have all of its impact on the rate at which prices and costs were rising and none at all on real growth. If this happened, one would move smoothly from an unsustainable rate of increase in spending to a sustainable rate of increase, without any risk of loss of output in the process.

Unfortunately, our markets are not that sensitive; prices and costs are not that flexible; competition in our economy is not that close to being perfect. Some producers, faced with a dampening of market conditions, may continue for a while to obtain increased prices, at the cost of a slower increase or a reduction in the volume of their output. But other producers may confront more competitive situations, and in the face of a slackening in demand in dollar terms for their products begin more quickly to find it difficult or impossible to continue to raise prices, even if they are only trying to pass on cost increases to final consumers. In order to avoid too great a squeeze on their profit margins they must make determined efforts to check increases in their costs. Sooner or later virtually all producers are in this position. That is fundamentally the way in which the control of the total level of spending affects prices and costs in the private sector of the economy. It works entirely through market forces.

One difficult feature of the process I have described is that there are bound to be important lags between the time when the rate of increase in total spending in dollar terms slackens off and the time when the full impact on the rate of price and cost increase in the economy is felt, unless the policies of restraint are drastic. The lag will be that much longer if those in a position to influence prices, wages and other incomes use their market power to resist the process rather than to facilitate the return to non-inflationary conditions. It should not be too surprising, given the lags

involved, if there is a temporary, rather discouraging period when we seem to be getting the worst of both worlds because the rate of expansion of the economy in real terms has slowed down but prices continue to rise for a while at much the same rate. It is important that we should understand the reasons why the economy may perform in this way, and not be too quick to lose heart in such a period or too ready to abandon policies of restraint before the job is done.

Turning now to recent economic developments, I believe that there is accumulating evidence that policies of restraint are beginning to take hold, both here and in the United States. If I may touch briefly on the situation in the United States first, I think that the evidence of a pronounced slowing in the growth of over-all demand has become a good deal more convincing during the past two or three months. Although a slowing trend had been suggested by the quarterly estimates of real Gross National Product for some time, corroboration in the important monthly indicators of the labour market and of industrial production has only been discernible in the very recent statistics.

Unfortunately, an accurate assessment of most of our own economic indicators since the first quarter has been complicated by a number of major strikes which have had an influence that is difficult to isolate. Even so, after making due allowance for all the temporary dislocations, it would seem that the underlying trend of demand in this

country is no longer increasing nearly as rapidly as it was in the period up to the first quarter of this year. For example, consumers appear to have been behaving more cautiously since the end of the winter. Exports, quite apart from the special difficulties in selling wheat, have clearly lost much of their upward momentum which was such an important expansionary factor last year. Most areas of investment spending still appear to be strong in Canada on the basis of surveys now available, but housing starts have been declining from the high levels reached earlier this year. Industrial production and non-farm employment (both of which, of course, have been seriously affected by strikes) have shown weakness in recent months, and this has been reflected in an edging up of the unemployment rate, which is now 5 per cent.

It is early to expect to see much impact of these developments on the trend of prices and costs, here or in the United States. It is, however, worth noting that in both countries profits, which increased very strongly during 1968, have levelled off or declined slightly in the first half of this year, and further pressure seems to be developing on profit margins. In Canada, the most widely used measures of prices, as you are no doubt aware, show slightly greater rates of increase over this year to date than they did during 1968. After seasonal adjustment, the Consumer Price Index increased at an annual rate of $4\frac{1}{2}$ per cent in the first nine months of 1969. The greater increase in the Consumer Price Index this year is almost

wholly attributable to the more rapid rise in shelter and other service costs. While such costs bear just as heavily on consumers as other prices, it has to be remembered that this area of the index is particularly slow to respond to any general easing of demand pressures since it includes many items that directly reflect wage and salary costs, as well as regulated charges, mortgage interest rates and property taxes. When one confines the analysis to the prices of goods, one does find in the recent statistics a few instances of reversals of earlier sharp increases of certain major commodities, but one does not find convincing evidence of any general moderation of price trends. Similarly, the typical wage and salary increases continue to be very large in relation to productivity, without evidence of a moderating trend. Nor is there conclusive evidence to date that inflationary expectations are on the wane.

In summary, while there are indications that policies of restraint are beginning to work and that we are on the right track, I think that it would be too optimistic to conclude that these policies have now done the full job of creating conditions that will eventually lead to a significant reduction in the rate of price and cost increase. In saying this I am well aware of the inevitable time lags that exist both in the adjustment of prices and costs to easier demand conditions and in the response of the economy to policy changes.

I wish that I could in good conscience come to a different conclusion. The Bank of Canada has no love for policies of restraint or for high interest rates in themselves. We are well aware that in the world as

it is constituted the effort to bring inflation under control may involve some slowing for a period in the rate of real growth of the economy. No more than anyone else do we wish to see any under-utilization of productive resources or any increase in unemployment. This is not the objective of an anti-inflationary monetary policy. On the contrary, the objective of policy is to create conditions which will encourage a prolonged and sustainable increase in output and employment.

Inflation is not such a condition. Quite apart from the serious inequities it involves and the unfair sacrifices it inflicts on those in the weakest bargaining position, including older people, the process of inflation and the attempts to adjust to inflation introduce tensions and distortions into the economic process which are bound to result in unsatisfactory economic performance. As more and more people try to adjust to inflation, more and more pressure is put on costs and prices and restrictive policies are needed simply to keep inflation from accelerating. Nothing is gained in the process in terms of output and employment and people are put to a substantial and unnecessary degree of inconvenience and anxiety in the attempt to keep up with inflation. It is taking a very short-run view to believe that the tolerance of inflation can result in a higher level of real output or less unemployment. Inflation jeopardizes the kind of long-run economic expansion on which durable growth in employment depends.

The antithesis which is sometimes set up between concern about inflation on the one hand and concern about employment and growth on the other is therefore, in my judgment, a false antithesis. There are undoubtedly real costs involved in the short run in bringing inflation under control. But these have to be weighed against the eventual real costs and inequities involved in failing to control inflation. For my part, I am certain that the real costs, in terms of output and employment, of failing to control inflation would in the end be much more serious. We need reasonable monetary stability for a number of reasons, but primarily as a means of maximizing our prospects of achieving high and efficient employment in the years ahead.

We must, of course, do all we can to keep the real costs of anti-inflationary policies to an absolute minimum. Because of the concern that I have had about minimizing these costs and obtaining the best performance from the economy over the longer run, I have for a number of years advocated that monetary and fiscal policies to influence aggregate demand should be supplemented not only by "supply" policies designed to improve the use, efficiency and mobility of our economic resources but also by an organized effort to influence public opinion in the direction of exercising restraint in the determination of prices and costs. It is for this reason that I have attached, and continue to attach, importance to the work of the Prices and Incomes Commission.

If we are to succeed in controlling inflation, we have to face the

fact that there is a very limited number of basic policies on which we can rely in a market economy. "Supply" policies, vitally important though they are, are necessarily long-term in character and cannot be expected to produce quick effects. They are more relevant to long-term productivity performance and regional balance than to the actual control of inflation. In the short run, major reliance has to be placed on the control of aggregate demand supplemented by voluntary restraint, if this can be arranged, or without it if it cannot. To the extent that those with market power are prepared to facilitate a return to non-inflationary conditions, the degree and duration of fiscal and monetary restraints will be reduced. It is obvious that much remains to be done to convince all groups in the economy that self-restraint is not altruism but a matter of practical self-interest because it can minimize the cost to the whole economy of controlling inflation. I hope that you who are listening to me are convinced that the businesses you represent should exercise the greatest possible restraint in their pricing policies.

In formulating monetary policy it is, of course, necessary to look not only at the current indicators of the economy but also to form as good a judgment as one can regarding possible developments in the future. The responsible authorities must keep their policies under constant review in the light of all the information that becomes available. Monetary policy is essentially forward-looking. This does not mean, however, that we can avert our gaze from what is going on around us. And it does not mean that in looking ahead we should take a very limited time horizon and be so concerned with the next few months that we fail to pay enough attention to the next few years.

All policy is in some degree based on forecasts and, as I am sure I need hardly remind this particular audience, experience has shown that economic forecasts are not always as accurate as we would like them to be. The prospective strength of the economy at any time is open to under-estimation as well as over-estimation and in recent years the tendency has been to err in the direction of under-estimation. It is necessary to appraise the risks in both directions. In a non-inflationary environment with the economy operating well below its potential, there is likely to be, and often should be, a willingness to take the risk that the economy may turn out to be stronger than is foreseen. On the other hand, in an inflationary period, and particularly one in which inflationary expectations have become very strong, and in which there is a firm underpinning of demand favourable to resumed expansion, one must be very conscious of the risks of premature relaxation. This would run the serious danger of confirming the expectations of those who think that when it comes to the crunch the authorities will lack the will to persist in policies of restraint and that inflation is here to stay.

One occasionally hears it suggested that we should not press the fight against inflation on the ground that since external prices have an important influence on our price level there is not much we can do on our own, and that we might as well leave the job to the Americans and spare ourselves all the inconveniences and the risks of anti-inflationary policies. I consider this course of action totally unrealistic. If this were to become the policy of the country, can there be any doubt as to what would happen to the expectations of Canadians in regard to inflation, or what would happen in the bond market

(on which not only industry depends for finance for expansion but on which provinces and municipalities depend to raise money for social capital needs), or as to what would happen in foreign exchange markets, or as to what would happen to domestic cost and price levels? Such a policy might be defensible if our inflationary pressures were entirely due to developments in the United States. While it is the case that prices in that country, particularly at the consumer level, have been rising more rapidly than in Canada this year, there is still plenty of evidence of domestically-generated inflation here, particularly on the cost side. There are important areas of the Canadian economy where our recent cost performance is worse than that of the United States. If we fail to do as well as the United States in controlling inflation the weakening of our competitive position over a period of time will damage our economic prospects for the future. On the other hand, if we were to do a little better in controlling inflation than the United States - something which may well be within our power - this would not constitute a problem. Such an outcome would be rewarding. There would be a pay-off in increased employment and output from our improved competitive position and our prospects for sound and sustained economic growth would be enhanced.

In times like these it is always heartening to stop for a moment to think of the capacity of the Canadian economy for growth and for the improvement of standards of life in this country. We should all keep in mind

how much can be accomplished in a relatively few years if we can get our policies right. In my opinion, the greatest threat to the full achievement of this fine potential is posed by inflation. There is no sector of our society which does not have a vital interest in the success of the effort that is now being made to deal effectively with this problem.

REMARKS OF LOUIS RASMINSKY
GOVERNOR OF THE BANK OF CANADA
BEFORE A MEETING OF THE CANADIAN CLUB OF MONTREAL
FEBRUARY 2ND, 1970

Remarks of Louis Rasminsky, Governor of the Bank of Canada, before a meeting of the Canadian Club of Montreal, February 2nd, 1970

This is about the time of year when many of us who find the Canadian winters a bit long begin to yearn for at least one sweet harbinger of spring, even though we know full well that reliable signs must still be some weeks away. In our impatience, we are in fact prepared to shift, if only for today, Groundhog Day, an uncommonly large share of the burden of long-range weather forecasting to certain creatures who are probably not even aware of their responsibility. I don't know how meteorologists feel about the forecasting record established by these particular specialists. Unlike economists, groundhogs have only one chance a year to engage in forecasting, but they do have the advantage of knowing that whatever their performance may be, spring always does manage to come within a few months.

If we turn to consider the economic climate, there are some similarities. Inflation has been going on for some time now; anti-inflationary policies have been in place for a considerable period; and there is growing impatience for some definite sign that the end is in sight. It has been a long cold winter in more ways than one. Unfortunately, the analogy breaks down at this point - there is no parallel to the inevitability of spring within a given number of months. I wish that I could express the comforting conviction that the end to inflation is close at hand, that all we have to do now is sit back and wait for the forces of nature to do their beneficent work. I

am afraid that I am unable to do this today. I do, indeed, believe that progress has been made and that we are on the right track in the struggle against inflation. But I think that if we really want to bring inflation to an end we shall have to continue to work at it. Moreover, I am convinced that we have no practical alternative to doing so, no matter how long it takes.

I am proposing in these remarks to begin by saying something about the way in which the main anti-inflationary policies have been developing - and it will not surprise you that I deal primarily with monetary policy since it is there that my own responsibility lies. I shall then try to account for the fact that these policies seem to be taking such a long time to do their work. Finally, I will talk a little about inflation itself and the reasons why I believe that we must persist in the fight against it.

For some time now, monetary policy has been strongly directed toward the reduction of inflationary pressures, and credit conditions have been steadily tightening. The cost of money, which is of course greatly influenced by external as well as domestic developments, has risen almost continuously since September 1968, to record levels.

The economic purpose of tight credit conditions is to influence businessmen and consumers to reduce the rate of increase in their total spending and so lessen the pressure of demand in the economy. These decisions, to spend or not to spend, are, of course, influenced not only by the cost of credit but also by its availability. Over the past year or two, it

has taken longer for a general restriction of availability to develop than it has for the cost of credit to increase. It is true that there was a substantial decline in the amount of long-term bonds issued in the domestic bond market in 1968 and a further reduction last year. But part of the decline was offset by increased borrowing in foreign markets. So far as the mortgage market is concerned, the willingness of borrowers to pay high interest rates resulted in the flow of funds into mortgages being relatively well maintained until the second half of 1969, when this too tapered off.

As regards bank loans, it took some time for the restrictive monetary policy to have a substantial impact on their availability. This occurred partly because in the autumn of 1968, when the present restrictive phase of monetary policy was initiated, the banks were very liquid, and partly because they have shown themselves willing, under the pressure of loan demand, to see their liquidity run down to considerably lower levels than had occurred in the post-war period. By the early months of 1969, the combination of the restrictive policy of the central bank, on the one hand, and the continued expansion in bank loans, on the other, had reduced the banks' ratio of more liquid assets to total assets to a not-excessively-comfortable figure of 30 per cent, and by April 1969 this had fallen below 29 per cent, to a new low. In that month, moreover, the Bank of Canada announced that it was using its power to raise the minimum secondary reserve ratio of the banks, which had the effect of impounding about $250 million of the banks'

liquid assets, thus making them unavailable to finance further loan expansion. As interest rates rose, there were several increases in the Bank Rate, which has been at 8 per cent since last July.

The central bank has continued to keep the cash and liquid positions of the banks under pressure in order to maintain an appropriate degree of tightness in the credit system. The ratio of the banks' more liquid assets to their total assets has moved down to around 26 per cent; the banks clearly have few resources to spare for additional lending.

A definite slowing in the rate of increase in bank loans occurred in May and June. The annual rate of increase in the aggregate of business and consumer loans in the second half of 1969 was less than 4 per cent. It is the case that, allowing for seasonal factors, some increase has occurred in the past few months when financial markets have been particularly tight and some outstanding commercial paper issued by corporate borrowers may have had to be financed directly or indirectly by the banks. Since the middle of the year the banks have kept their consumer loans from expanding, and as banks account for nearly half of the total amount of consumer credit extended, the rate of increase in total consumer credit outstanding in the economy has now slowed down considerably.

The effects of monetary policy on the banking system show up clearly in the broad aggregates. Despite some upward movement in November and December, the total assets of the banks have grown at an

annual rate of only 2 per cent since mid-1969 - 5 per cent for the whole of the year. The total amount of currency outside banks and bank deposits held by the general public, the privately held money supply as broadly defined, was lower in December than in the previous March and rose by less than 4 per cent in 1969.

In addition to relying on its normal techniques of operation, the Bank of Canada has asked for and received the co-operation of the chartered banks on a number of matters. In response to requests by the Bank of Canada, the large chartered banks have not been competing aggressively for large blocks of short-term funds through the sale of Canadian dollar instruments. As an additional measure to help to avoid too great a general escalation of short-term rates, and to protect Canadian interest rate levels against part of the very sharp rise in rates in the Euro-dollar market, the chartered banks in July agreed to place a ceiling on their swapped deposits, i. e., Canadian dollar funds which have been converted into a foreign currency and placed on term deposit with a bank, and which the bank has undertaken through a forward contract to convert back to Canadian dollars at maturity. In pursuit of the same objective I last week asked a number of other financial institutions not to frustrate the effect of the ceiling on swapped deposits by arranging similar transactions in other ways. In another field, in order to soften the impact of tight credit conditions on less prosperous areas of the country, the Bank of Canada has asked the chartered banks to

have special regard for borrowers in those areas. We have also asked the banks to have special regard for small businesses throughout the country since, unlike large corporations, they do not normally have alternative sources of credit. The Bank has also expressed the view that the chartered banks should maintain a reasonable continuity of lending on housing mortgages. Finally, in view of the higher bank loan rates now prevailing in the United States, which gives U.S. corporations an incentive to borrow here directly or through Canadian subsidiaries, it was suggested to the chartered banks that they should give priority in the use of their total loan resources to the credit-worthy demands of their Canadian customers.

Although the general impact of monetary policy has spread through financial markets and affected all financial institutions, the strong demand for mortgage funds and consumer credit has led to an increased rate of growth of non-bank financial institutions such as trust and loan companies and finance companies who have been able to pay higher rates on the funds entrusted to them. This, together with the expansion of the commercial paper market, to which I shall refer in more detail in a moment, has produced some offset to the decline in the rate of expansion of bank credit.

One of the reasons why monetary restraint has taken a considerable time to have its full impact is precisely this wide variety of sources of credit available to some borrowers. The rapid growth of the commercial

paper market in the last half of 1969, frequently with short maturity terms that are not related to the real requirements of the borrower but rather to the desire of the investor to stay liquid, is a good example. There are, however, limits to the extent to which such channels for obtaining credit can expand, and the degree of strain that was evident in the commercial paper market towards the turn of the year may be an indication that the rate of expansion was somewhat overdone. Another example of the way in which the impact of credit restraint may be delayed is through the slowing-up on the part of some businesses of settlement of their accounts payable. This process tends to push the burden of credit stringency back onto large suppliers who may have better access to bank or other credit than their customers. Once again, there is a limit to the extent to which this channel can be used. My own impression is that, taking not only the banking system but all other channels of credit into account as well, credit conditions have become progressively tighter, reflecting the steadily growing impact of monetary policy on the availability of credit.

Fiscal policy has also been playing an important role in the effort to restrain the growth of total spending in the economy. The rate of increase in Government of Canada expenditures has slowed, and the over-all cash position of the Government has improved markedly over the last year. This is well known. What is probably not as well recognized is that the improvement in the fiscal position of the Government of Canada has also

been of great assistance in enabling the central bank to keep the liquidity of the banking system under control. In the last twelve months there has been no increase in the amount of Government of Canada market issues outstanding. This fact has been of help to the Bank of Canada in its policy of squeezing liquid assets (largely Government securities) out of the banking system and getting them absorbed by non-bank investors. In 1968, by way of contrast, the Canadian dollar market issues of the Government of Canada outstanding increased by over $1 billion and, despite successful efforts to achieve some increase in non-bank holdings, it was not possible in the circumstances of the time to avoid a large increase in bank holdings of Government securities, and consequently in bank liquidity.

So much by way of description and explanation of the anti-inflationary policies that have been followed. The main burden has necessarily fallen on the broad instruments that influence the total level of demand, or of spending, in the economy, that is, on fiscal and monetary policy. Other policies which deal with the supply side of the equation - which aim at increasing the efficiency and mobility of our resources - are of basic continuing importance. Such policies, including important activity in retraining and developing labour skills, have been and are being actively pursued by the Government. But unfortunately they yield their valuable fruits only over a considerable period of time and make little contribution to the urgent problem of controlling inflation now.

What, then, can we say about the effectiveness of the policies which have been followed? I believe that there is considerable evidence that these policies have had an important influence on the total level of spending, though this slow-down of spending appears, up to the present, to have had more impact on the level of output than on the rate of price increase. However, we can claim, as a minimum, that the acceleration in the upward push of prices has been stopped. Had vigorous policies of demand restraint not been used, the increase in our prices and costs would certainly have been even greater than has been the case.

Some considerable slowing down in the rate of economic expansion occurred in both Canada and the United States in 1969. In the United States, where the over-all stance of monetary and fiscal policy has also been restrictive, the signs are very clear. The growth in total output, which was running at an annual rate of $6\frac{1}{2}$ per cent in the first half of 1968 and had slowed to $2\frac{1}{2}$ per cent by the first half of 1969, averaged about 1 per cent in the second half of last year. The Canadian economy continued to grow at a very rapid rate in real terms up to the end of the first quarter of 1969. Since that time I think there can be no question that the pace of expansion has slowed markedly, but the conventional measures of activity are extremely difficult to read owing to the number of major strikes which developed in the second quarter of the year and continued to affect important sectors of activity until well into the fourth quarter. For this reason, I am inclined to believe that the underlying rate of growth in the Canadian economy since the first quarter of last year may have been a bit stronger than is

suggested by such indicators as GNP or industrial production.

In contrast to the U.S. situation, where the labour market remained very tight all through 1969, the over-all unemployment rate in Canada is currently close to 5 per cent. In some parts of the country it is considerably higher. Unfortunately, the persistence of a somewhat easier labour market in Canada in 1969 has not as yet been accompanied by any discernible improvement in the performance of prices and costs. On the contrary, the consumer price index over the past twelve months increased by 4.6 per cent compared to an increase of 4.1 per cent over the preceding twelve-month period. On the cost side, the evidence is no more encouraging. Average weekly wages and salaries in Canada continue to show a year-to-year gain in the range of 7 to 7½ per cent, which was greatly in excess of the trend of productivity increases, let alone of the negligible productivity growth that actually occurred over the past year.

To sum up, we have been witnessing a situation in which the growth of the economy has been markedly slower for almost a year, while prices and costs have continued to rise at an extremely unsatisfactory rate. Does this mean that our policies are not working? I do not think so. Since the middle of last year there has been evidence that business is finding it increasingly difficult to pass on all the increase in its costs in the form of higher prices. This is reflected in the squeeze in profit margins which has been developing in recent months. I think this development suggests that the policies of restraint

are beginning to bite. As it becomes increasingly difficult to absorb large increases in costs in this way, business corporations will have to intensify their efforts to slow down cost increases.

Let me now turn to the question, why have the policies of restraint taken so long to have their effect on prices and costs?

Given the way in which our economic system works, some lags between the slowdown of spending and its effect on prices are , to be sure, inevitable. But even after allowing for this there are, I think, two special factors which have contributed to the disappointingly slow progress in checking inflation. One of these is the seriousness of inflationary pressures abroad. It is an unhappy fact that prices last year in nearly all the industrial countries increased at rates much above the long-term average. This phenomenon undoubtedly has added to our own problems, both by its direct effects on Canadian prices and by its indirect effects on Canadian attitudes toward price behaviour and income determination. However, having said this, I would like to remind you that the authorities in other countries are also striving to deal with their inflationary problems. While our own progress will be seriously hindered until others deal effectively with their situation, we must not be lulled into believing that for this reason it is up to others to solve our inflationary problem for us. It would be all too easy for us to fall behind in the effort to deal with inflation. Rather, we should try to stay a step ahead of others for this would be much to our advantage in terms of exports and employment.

The second special factor that explains the delay in the effectiveness

of public economic policy has been the development of strong expectations of continued inflation. The effectiveness of monetary and fiscal policies, which operate in large part by influencing the incentives to spend, must depend to a very considerable extent on the behaviour of a very large number of individuals and corporations; and this behaviour has been greatly influenced during the past two or three years by the prevailing expectations about the trend of prices and incomes. In the monetary field, the most striking evidence of inflationary expectations has been the attitude toward high interest rates. Long-term Government of Canada bond yields are now over 8 per cent and prime conventional residential mortgage rates about $10\frac{1}{2}$ per cent. The demand for credit on the part of private corporations, individuals and governments has been very strong, but I do not think that it is possible to explain the present high level of interest rates, or their failure to exercise more restraint up to the present, except in terms of inflationary expectations on the part of investors and borrowers alike.

The problem I have just been discussing is, of course, not unique to ourselves - much the same kind of inflationary psychology exists in the United States for similar reasons. Public policy must continue to be directed to bringing these inflationary expectations to an end. Expectations can change very rapidly and those who are gambling against this happening are doing so at their own risk.

I believe that most people are quite opposed to inflation and are anxious to see it stopped but there are a number who are now asking whether the cure is not worse than the disease and whether we would not do better to live

with inflation. Certainly, people receiving substantial increases in money incomes at least for a time do not give much thought to how much of the increase is bound to be illusory because it will get eaten up by higher prices. There is also naturally some fear that the attempt to deal with inflation may carry restraint to the point where the economy is pushed into a recession. This is a consideration which has to be in the minds of the public authorities at all times. So too must the hardships involved in the incidence of necessary anti-inflationary measures not only on individuals, but on regions of the country where unemployment levels are unusually high and where policies of restraint therefore seem inappropriate, and on some particular sectors of the economy where the restrictive measures bear most heavily.

But in the final analysis, taking all these difficulties into account, I do not feel that the acceptance of inflation is a feasible alternative to the policies we are now following. In saying this I have in mind the inequities of inflation, its serious impact on the poor, the retired, the elements in the community with the least bargaining power. I have in mind the harm that inflation does to the prospects for sustained economic growth, by undermining reliable standards of value and encouraging speculation, waste and inefficiency. I have in mind the distorting effects on capital markets, including the particularly severe impact on the availability of funds for social capital. I have in mind its undermining effects on our international competitive position. And I have in mind that all these inequities, hardships and distortions are suffered for no good purpose, for no gain in real output which can be counted on to persist over

an appreciable period of time. The so-called stimulating effects of inflation depend on being able to pick people's pockets successfully. But people cannot be fooled indefinitely, and when they realize what is happening, more and more seek to protect themselves by using their bargaining power in the effort to keep ahead of the game. This, of course, cannot fail to accelerate the process and at a certain level - whether it is 4 or 5 or 6 per cent a year - the degree of inflation becomes intolerable and restrictive measures, with all their difficulties, have to be used simply for the purpose of keeping the inflation from accelerating further.

To sum up, I think that the only conclusion that it is possible to reach is that even though we find the process disappointingly long, there is no alternative that would not be worse. We must stay the course, we must persist in the fight against inflation. In view of the length of the effort that has been and may continue to be required, I believe that this means that in addition to over-all measures of restraint, we shall have to lay increasing emphasis on trying to develop selective policies - policies which are designed on the one hand to blunt the sharp edge of restraint on particularly exposed sections of the community and particular areas, and which are designed on the other hand to pinpoint the sources of inflationary pressure and try to deal specifically with them.

The period of time during which it is necessary to retain restrictive over-all policies, and suffer the loss of employment and output involved,

could be considerably reduced if agreement could be reached by all sectors of the community to shorten the lags in the effectiveness of the broad policies affecting demand by exercising moderation in price and cost decisions. There is no moral judgment involved in making this statement, no attempt to attribute blame or responsibility for the present position. The fact of the matter is that we are all caught up in a process of action and reaction from which all suffer and which it is in everyone's interest to bring to an end as soon as possible. The Prices and Incomes Commission has recently taken an important initiative which deserves the full support of the whole community.

The potential of our economy for the 1970's is very great. But let us not deceive ourselves. We can spoil our chances of reaching it if our over-all situation is one in which continuous efforts are being made to adjust to inflation and in which restrictive policies have to be applied merely to keep inflation from accelerating. I have enough confidence in our good sense to believe that we shall reject this as a way of life. I believe in fact that we are now well embarked on this process of rejection.

REMARKS OF LOUIS RASMINSKY
GOVERNOR OF THE BANK OF CANADA
BEFORE A MEETING OF THE CANADIAN CLUB OF VANCOUVER
APRIL 28TH, 1971

Remarks of Louis Rasminsky, Governor of the Bank of Canada, before a meeting of the Canadian Club of Vancouver, April 28th, 1971

While I have had several occasions to address British Columbia audiences during the past few years, I am particularly pleased to have been invited back at this precise time. In a few months, you will be marking the centenary of your entry into Confederation, and I am grateful for this opportunity to extend to you my best wishes for your next hundred years.

I was prompted by the occasion to refresh my memory of the early history of British Columbia's association with Canada. My researches revealed much that was truly inspiring and also much that was, for an Easterner anyway, rather disconcerting. I found, for example, that Senator W. J. Macdonald, who played an important part in the affairs of this part of the world for twenty years before Confederation, wrote to a leading political figure within two years of that event: "The present administration must be very distasteful to you.... and as you remark, not one of them that you would care to have for a friend, or to ask to your house". The same sweeping judgment of Canadians is to be found in the letter of the wife of an outstanding British Columbia member of Parliament on the occasion of her first visit to Ottawa: "I never in my life saw such a collection of downright ugly and awkward looking men".

I can only express the hope that such judgments have mellowed

over the years and that the historian of British Columbia, Margaret Ormsby, had a better perspective when she wrote "for the crowds of Canadians who had gathered on the streets of Victoria at midnight on July 19, 1871 to hear the bells rung and the guns fired, and to see the Roman candles lighted, the arrival of the first corps of railway surveyors in August 1871, had promised the enlargement of professional, commercial and political opportunity".

This promise has, I think, been amply fulfilled, in spite of occasional difficulties and set-backs. No part of the country has grown more rapidly than British Columbia and no part holds out greater promise of still further growth. Over the past quarter century, an extraordinary spurt in the economic development of British Columbia has taken place and the rapid growth in job opportunities has led to the doubling of the Province's population since 1948. The past decade alone has seen employment rise by nearly 60 per cent, almost twice as rapidly as for Canada as a whole, and personal income has risen by an impressive 125 per cent. You are richly endowed with natural resources in your forest, mining and power industries and are constantly developing new ones. You have been rounding out your resource base by increasing the range of your manufacturing and service industries and adding to your capacity for self-generating growth. Vancouver has come to play an increasingly important role as a financial as well as a commercial centre and the past couple of years have witnessed the establishment of the Bank of British Columbia with its head office here. The

Bank of Canada has recognized the growing importance of Vancouver as a financial centre by permanently stationing officers here to keep in touch with these developments and give what help we can.

I would also like to think that during the past quarter of a century, the Industrial Development Bank, a subsidiary of the Bank of Canada, has played a significant, if modest, role in fostering industrial development in the Province. As you may know, the IDB was set up to help in the development of smaller businesses which need additional fixed term capital but which, because of their relatively small size, or lack of an established earnings record, or their geographical location, have been unable to obtain the required financial assistance elsewhere on reasonable terms and conditions. It is of interest to recall today that during its first year of operation the IDB made seven loans in British Columbia for a total amount of $138,000 from one branch office in Vancouver. Twenty-six years later, in 1970, it authorized over 1,000 loans totalling nearly $50 million to businesses of all kinds in the Province. We now have branch offices in Kelowna, Prince George, New Westminster and Victoria, as well as Vancouver, and will shortly be opening a new branch office at Cranbrook. At the close of its last fiscal year the IDB had $121 million outstanding or committed to more than 2,500 businesses in British Columbia representing every type of business activity in the Province from fish plants, tugboats, bulk loading wharves, lumber

mills, manufacturers and retail stores to ranches, motels, ski resorts, etc. Moreover, decisions on more than 90 per cent of the loan applications received from businesses in the Province itself are taken right here, without any need for reference beyond the local branch or the regional office in Vancouver.

Having dwelt a little upon the impressiveness of British Columbia's economic achievements when viewed over the broad sweep of years, I would be remiss if I did not also recognize the fact that during the past year or more you have had to face some difficult economic problems. I am thinking in particular of the problems of the forest industry associated with the rapid expansion in capacity since the mid-1960's, the slowdown of the North American economy, and the appreciation of the Canadian dollar. You have also had more than your share of labour disputes and during the past winter your unemployment rates were very high, in part as a result of the migration of unemployed people from other provinces. But in the past few months there have been signs that some, at any rate, of these problems are diminishing, as the faster pace of house-building activity in Canada and the United States revives the lumber market and as the economy as a whole shows signs of moving forward more rapidly. Another hopeful sign for this Province is the relatively strong investment outlook for 1971 -- the indicated increase for British Columbia is very much larger than for other regions of the country.

This leads me to the matters which I would like to talk to you about in the balance of my remarks today. First, I would like to deal with the problem which is foremost in everyone's mind at the moment, namely that of increasing the rate of growth in our economy and reducing unemployment from its present unacceptable level. I want, in particular, to tell you what the Bank of Canada has been doing about it. Then I would like to talk a little about some of the problems for policy in the period which lies a bit further ahead but which I think we need to be thinking about right now.

At the outset, I want to make it very clear that since the early months of 1970 monetary policy has been used vigorously to encourage a more rapid rate of growth in output and employment in the Canadian economy.

The contribution of monetary policy has been made by providing the banks with sufficient cash reserves to permit a substantial rate of growth of the financial system. This has contributed to much easier credit conditions in Canada, that is, to a much greater availability of, and to a much reduced cost of, borrowed money. Easier credit conditions have encouraged the growth of output and employment in Canada in two ways. They have made it easier for Canadians to undertake spending programs in Canada that are financed by borrowed money, and they have moderated the sharp upward pressure on the foreign exchange value of the Canadian dollar and in so doing have moderated the extent of the adverse impact of the exchange rate on our

export industries and on our domestic industries which compete with imports.

A striking illustration of the easing of monetary conditions over the past year can be seen by comparing the level of interest rates today with those prevailing in the first quarter of 1970. The treasury bill rate, which was about 7 3/4 per cent during the first quarter of 1970, is currently at about 3 per cent, its lowest level since 1962. Other short-term rates have shown equally sharp declines. The fall in long-term interest rates has also been appreciable -- about one to one and a half percentage points -- though these rates remain unusually high in relation to the level of short-term rates.

The changes in the size and liquidity of the banking system also provide impressive evidence of the change in credit conditions that has taken place over the past year. For the twelve months ending March 1971 the major assets of the Canadian banking system increased by 13 1/2 per cent and the liquid asset position of the banks has recovered to the point where banks are anxious to make credit available to all creditworthy borrowers. This has, indeed, been the position for some time, and the banks' business and personal loans have increased at an average annual rate of about 15 per cent over the past five months. The increase in the money supply over the year ending March 1971, using a broad definition -- currency plus total privately-held bank deposits -- was 14 1/2 per cent compared

with an average annual increase during the 1960's of 8 1/4 per cent.

As I have said, one of the major considerations that has led the central bank to follow a strong expansionary monetary policy in the last twelve months has been a desire, in the prevailing economic circumstances, to moderate the sharpness of the increase in the foreign exchange value of our currency after massive inflows of foreign exchange led to the freeing of the exchange rate last May. It is sometimes urged as an advantage of floating exchange rates that under this system the public authorities need not concern themselves about the state of the balance of international payments since this will automatically be kept in equilibrium by the exchange rate that emerges in the market from time to time. But this freedom to be unconcerned is one that no responsible monetary or fiscal authority could in fact indulge in. The reason is of course that the exchange rate itself, which produces the equilibrium in the exchange market, is far too important a price in the economic life of a trading nation to be ignored. I hardly need remind British Columbians of the problems which a considerable appreciation of the exchange rate can create for major export industries under certain circumstances, and of the uncertainties it entails in planning future investment. It also creates difficult problems for many sectors of domestic manufacturing industry which compete with imports or which have been successful in breaking into export markets. The growth of such industries

has been an impressive feature of our economic development in recent years and one that we would all wish to see continue.

For these reasons it has been a proper, and indeed an inevitable, concern of the Bank of Canada to endeavour, within the limits of a reasonable monetary policy, to ease the upward pressure on the exchange rate by encouraging credit conditions in Canada which reduce the incentives for Canadian borrowers to go abroad for funds and for non-residents of Canada to employ their funds in Canada.

In order to reinforce this approach to a desirable development of Canada's external payments position, which has, as you are aware, recently been characterized by a large surplus on current account, the Minister of Finance and the Bank of Canada have been asking Canadian borrowers to explore carefully the possibilities of doing their financing in Canada before they look abroad for funds. The Minister of Finance has recently released a letter reiterating and explaining this request, and I want to take this opportunity to make it clear that I continue to support this initiative. I regard it as very much in the national interest that all borrowers, whether they be public or private institutions, do as much of their financing in Canada as it is feasible for them to do. Since all regions of Canada will benefit in terms of production and employment, it is no more than a matter of enlightened self-interest, in the current economic circumstances, to

co-operate in minimizing the upward pressure on the Canadian dollar which foreign borrowing tends to induce.

I now conclude this part of my remarks. I have burdened you with some figures indicating the rate of growth over the last year in the money supply, and with figures indicating the reduction in cost and the increased availability of borrowed money. I have done so because I want you to be aware of the extent to which monetary policy has been concerned with encouraging an increase in the rate of growth of production and employment in Canada. I have always been and I continue to be an advocate of flexibility in monetary policy, and I regard the expansionary policy of the Bank of Canada over the past twelve months as being warranted by and appropriate to the prevailing economic circumstances. At the present time there is certainly no shortage of money or credit to keep the Canadian economy from moving forward strongly.

May I now give you my personal assessment of how this policy has been working.

How clear are the signs that a revival of economic growth is under way? As is often the case in appraising the current economic situation, the evidence is less clear-cut and unequivocal than one would like. However, I believe that the recent evidence is encouraging. Total output in the economy rose substantially in the fourth quarter of 1970 and it appears that a good

rate of growth has continued in the quarter just ended. The up-turn in output in the past half year has been accompanied by a modest reduction in unemployment after allowing for the adverse seasonal factors, though the actual level of unemployment is still too high. The seasonally adjusted unemployment rate appears to have reached a peak of about 6 3/4 per cent at the end of last summer, and since that time it has edged down to 6 per cent in March. We seem once again to be in a phase of general economic expansion, though there will no doubt be occasional hesitations and set-backs.

In the United States, as in Canada, a period of stronger economic expansion now seems to be getting under way. This will, of course, tend to underpin and reinforce our own recovery.

In short, it seems to me that a principal objective to which our economic policy has been directed in the past year is in the process of being realized, and that we can look forward to a good rate of economic expansion and to a continued reduction in the present high level of unemployment.

I would like finally to make some very brief remarks about some of the concerns for policy that lie a bit ahead, as the economic expansion gathers momentum. One concern must, of course, be to try to ensure that the on-going rate of growth in the economy is sufficient to ensure a steady reduction in the rate of unemployment. Given the relatively high rate of

potential growth which we have in this country -- between 5 and 5 1/2 per cent by the usual reckoning -- it is apparent that we must aim, as we are doing, at achieving a rate of growth that is higher than this in order to bring unemployment down. This is an ambitious target but, as I have already tried to indicate to you, I think that the degree of easing which has occurred in monetary policy has been such as to facilitate a revival of this magnitude. In addition, we must not forget that fiscal policy too has been significantly expansive, and the Government's financial position shifted from modest cash surplus in the previous fiscal year to one of large borrowing requirements in the year just completed. In trying to assess the adequacy of the degree of stimulus provided by fiscal and monetary policy in the past year, it is important to remember that these policies do not have instantaneous effects on the economy. Indeed, the lessons of the last year or two remind us once again, all too painfully, that the lag between action and effect can be long. In present circumstances, this means that some of the fiscal and monetary stimulus applied in the last year to speed up the process of economic recovery has not yet had its full impact.

It is, of course, natural for us to wish to see as rapid as possible a rate of expansion, but we must balance this against the risk of creating

so steep an upsurge in the economy that it would inevitably invite a repetition of the go/stop process which we all wish to avoid. The essence of policy, in present circumstances, must be to try to achieve on the one hand a rate of growth which is strong enough to ensure a steady reduction in unemployment while at the same time avoiding an expansion so rapid that it would over-shoot the mark. To over-shoot the mark would press the economy too hard against its physical limits for a period before the rate of demand growth could be moderated to what the economy can accommodate on a continuing basis and would generate a new wave of demand inflation. This danger was well set forth in greater detail than I can attempt today in the Economic Council of Canada's publication "Performance and Potential", published last September.

In thinking about these matters, we also have to keep in mind that we are commencing this new period of economic expansion before the process of cost inflation has been brought completely under control. We still have a pattern of increases in wages and salaries that is considerably in excess of our long-term productivity growth and which is not consistent with the maintenance of our recent price performance. In the past year the consumer price index rose by about 2 per cent, a very low figure by international standards, but this gives an unduly favourable impression of the underlying trends in the economy. The kind of erosion of profits and

contraction in farm income which occurred last year, and which, along with the rise in the exchange value of the Canadian dollar, was a major element in the improved price performance, is something which cannot be expected to continue.

If we are to achieve a sustained economic expansion without the recurrence of serious inflation, there must be in the months ahead some downward adjustment in the average rate of increase in wages and salaries and other incomes. This is not out of the question and it may in fact be taking place to some degree. The improved productivity performance which normally accompanies a stronger rate of economic expansion should also help. But as long as wage and salary increases remain far in excess of long-term productivity gains we run a real risk of deteriorating price performance. For this reason, it seems to me to be still necessary -- tiresome though reiteration is -- to continue to focus public attention on the need for moderation in the setting of prices and incomes and to seek new ways to bring the common interest to bear more effectively on decisions in these areas. If such efforts fail and prices again start to rise rapidly while unemployment rates remain high, there is bound to be increasing support for formal controls to curb the present freedom to determine prices and incomes, even though it is far from clear that such controls would in fact be workable for long or that they would not create very difficult problems of their own.

Inflationary developments outside Canada obviously complicate

our own efforts to move the economy forward at a brisk pace without triggering off rapid price increases. But for my part, I do not feel that we can afford to take a relaxed or defeatist attitude because the progress of some other countries in bringing inflation under control is discouragingly slow. In our own interests we must continue to be concerned to reduce to a minimum the domestic sources of inflation.

Mr. Chairman, I have tried in these remarks to outline the contribution that the Bank of Canada has been making to the task of encouraging more rapid economic expansion and reducing unemployment. I have tried to give you some impression, on the whole an optimistic one, of the direction in which I think the economy is moving. At the same time I have said something about a few of the problems that seem to be ahead. I fully realize that it may seem premature to some of you for me to be expressing concern at this point about the possibilities of further inflation when the economy is so clearly operating well below its potential. But I think that it is only prudent, even though our most immediate concern is the present high level of unemployment, that we should be giving thought to the best way of avoiding inflation in the future. There is a natural tendency to focus our entire attention on the economic problem that is most pressing at any particular time: but if we do not keep in mind all our economic objectives all the time, we can only contribute to unsatisfactory economic performance with alternating periods of inflation and high unemployment. We must strive to do better than this.

REMARKS ON "MONETARY POLICY" BY

J.R. BEATTIE, DEPUTY GOVERNOR OF THE BANK OF CANADA

AT THE BUSINESS OUTLOOK CONFERENCE OF THE CONFERENCE BOARD

TORONTO, OCTOBER 7, 1971

Remarks on "Monetary Policy" by
J.R. Beattie, Deputy Governor of the Bank of Canada
at the Business Outlook Conference of The Conference Board
Toronto, October 7, 1971

I am glad to have this opportunity of speaking about developments in the field of monetary policy. The last such reporting was in June when the Governor appeared before the Senate Committee on National Finance, and quite a lot has happened since then. We know that a period of great disturbance in the economic weather set in on August 15, accompanied by dense fog.

We can still only guess at whether or how the climate may have changed, and just what the environment will look like when the fog has lifted. Nevertheless, some things have become clear in the weeks which have elapsed since President Nixon announced his New Economic Program. It is widely accepted that substantial adjustments in the balance of payments of the United States - and consequently also of other countries as a group - are going to be made in one way or another. The need to work out the adjustments cooperatively and within a framework of expanding trade is clearly seen. So is the need to avoid protectionist measures which would lead to a cumulative spreading of restrictive practices and damage to all countries. But just how, within this broad spectrum, the adjustments will actually be made is still an open question. The answer will probably be more important for Canada than for any other country.

Needless to say Canada also has a deep interest in the results of the United States effort to get control of its price-cost spiral. The degree

of United States success in coping with its twin problems of inflation and unemployment will greatly affect the ability of Canada and other countries to deal with their similar problems.

You will understand, therefore, that it is exceptionally difficult right now to appraise what we face. It would clearly be out of place to have inflexible views about the deployment of monetary policy or of other policy instruments which the Canadian authorities could use for influencing the course of developments in our financial markets and our economy. Because of these major current uncertainities about the kind of situation we are now in, I will devote less of my allotted time than I normally would to recent economic and financial developments, and talk a bit more about some matters of longer run interest.

Through the summer there were encouraging indications of gathering expansion in the Canadian economy. The second quarter National Accounts showed that the constant dollar GNP was growing at a seasonally adjusted annual rate of 8 1/2 per cent. There are always statistical fluctuations even in such a broadly based series but if we average the increase over the previous three quarters, it was still at a rate of 6 1/2% per year. These figures are well in excess of the average annual rate of growth in our potential output, which is generally reckoned at 5 1/4 to 5 1/2 per cent per year. Productivity increases were relatively high, as they usually are in a recovery period, and there was also an increase in the rate of participation in the labour force; together these factors have so far blunted the impact of rising output in

reducing unemployment. Nevertheless, in the pre-August 15 period our economy seemed to be firmly moving into a situation of satisfactory growth and declining unemployment.

On the other hand, the rate of increase in our consumer price index was rising again; the seasonally adjusted annual rate of increase in the total index has recently been about 5 per cent and even excluding food about 4 per cent. Wholesale prices have been rising somewhat more than retail prices, and the increases in average hourly earnings and in wage settlements have been showing signs of accelerating again.

The recovery which began in the latter part of 1970 owed much to expansionist fiscal and monetary policies. In the fiscal area the federal government's position (net of foreign exchange financing) swung from a cash surplus of $400 million in 1969 to a cash requirement of $350 million in 1970 and of $1.3 billion on an annual rate basis in the first eight months of 1971. The June Budget forecast a cash requirement in the fiscal year ending March 1972 of $2.4 billion.

The large swing in the fiscal position was accompanied by, and was indeed mainly responsible for, a similar swing in the growth of the monetary aggregates. The rate of increase in the public's holdings of currency and chartered bank Canadian dollar deposits, which is the most commonly used definition of our "money supply", was 4 per cent in 1969, 11 per cent in 1970, and 15 per cent on an annual rate basis in the first nine months of 1971.

The chartered banks' liquidity ratio, whose movement is an important indicator of central bank policy, declined from 31.9 per cent at the end of 1968 to 27.6 per cent at the end of 1969, rose to 31.3 per cent in May 1971 and was 31.0 per cent in September 1971. Partly as a lagged response to these changes in bank liquidity and partly because of changes in the demand for credit, the chartered banks' general business and personal loans increased by 13 per cent in 1969, by 5 per cent in 1970, and by 14 per cent on an annual rate basis in the first nine months of 1971.

As you know, short and long interest rates rose steeply in 1969 to historically high levels. They declined considerably in 1970, especially at the short end, and then increased moderately through the middle of 1971 until August 15. Since then many categories of interest rates have declined moderately, particularly at the long end of the market which may indicate some lessening of inflationary expectations.

Some may be concerned that recent monetary policy has been too expansionary, particularly those who regard changes in the rate of growth of the money supply as the main indicator of central bank policy. Monetary policy must, however, also have regard for the accompanying impact on interest rates. Given the public and private demand for funds which has existed, keeping the increase in the money supply appreciably lower would have resulted in higher short term interest

rates than those we have experienced. This would have exerted some drag on domestic economic recovery both directly and through encouraging short term capital inflows which would have pushed up our exchange rate further, with consequent discouragement to exports and increase in imports. It will be clear that monetary policy has recently given a high priority to avoiding an exchange rate that was inappropriate to our economic circumstances.

Apart from the question of how much monetary expansion there has been in total over recent years, there is room for difference of opinion about the degree of variation in the rate of increase which has occurred from time to time. Some have suggested that it would be better to have a more "even-handed" approach to monetary expansion. Proponents of this view feel that the "money supply" should be increased at a steady rate; a rate equal to the rate of growth of the economy's potential (say 5 1/2% per year) has frequently been suggested. In assessing this view of monetary policy there are several points to consider.

First, the precise definition of the "money supply" is of crucial importance since different definitions normally show quite different rates of growth and different degrees of fluctuation. It is a disturbing aspect of the "even-handed" view that so much should depend on a matter of definition which is apparently arbitrary and usually unspecified.

Second, one would like to see clear evidence of a stable relationship between the "money supply" (however defined) and constant dollar GNP. The

empirical work that does exist does not provide firm enough evidence to justify a "money supply" policy in Canada.

Third, the question of what constitutes "steady" growth is usually left imprecise. Most proponents would probably concede that "steady" should not be interpreted literally on a month-to-month or perhaps even a quarter-to-quarter basis, and they concede that some bending of the rule is needed when the circumstances are unusual. Since unusual things seem to be happening rather frequently, the rule of "steady" growth turns out to be not very helpful as a practical basis for central bank operations.

Fourth, if for whatever reason rapid monetary expansion is taking place outside Canada and external short term interest rates become relatively low, especially in the United States, Canadian monetary policy is bound to be affected in some degree. An attempt to maintain substantially tighter conditions in Canada than prevail externally encourages short term capital inflows; if the Government finances the resulting Exchange Fund cash requirement outside the banking system, then interest rates are likely to rise and cause an upward spiralling of the inflow; eventually Exchange Fund accretions become so large that they have to be financed within the banking system and the resulting increase in bank liquidity brings Canadian short term interest rates down and checks the inflow. Alternatively, under a floating exchange rate, the Canadian dollar will appreciate until monetary policy is eased enough to check it.

It is worth noting that even in a huge, relatively self-contained economy like that of the United States recent efforts to achieve a steadier rate of monetary expansion have not prevented continued large fluctuations in the favoured definitions of money supply. Unless and until an "even-handed" policy with regard to money supply growth becomes operative in the United States and other major countries in some meaningful sense of the term, there surely isn't a chance of it being tenable in a small, open economy like Canada's.

Granted the external constraints under which monetary policy must operate in an economy like ours, these may from time to time limit what the central bank can do to help promote price stability and maximum sustained growth in Canada. At such times more of the job of achieving these basic objectives falls to fiscal policy or other elements in public policy. Increasing recognition of this situation in many countries has led to a growing concern about what is called the "mix of policy", and ways of improving it.

The mix of policy is important in any case because monetary and fiscal policy differ considerably in their impact on different parts of the economy. The effect of monetary restraint tends to fall relatively heavily on borrowers in the non-corporate sector and in general on marginal borrowers; it operates through the market and cannot be pin-pointed to any great extent. Changes in fiscal policy, i. e. in taxes and government expenditure programmes are more capable of being directed towards particular sectors or regions of the economy; they are less flexible as to timing, but there has been considerable improvement in this respect in recent years.

Both monetary and fiscal policy are subject to distressingly long time lags - of up to a year or more - before their full effect is felt. This is one major reason why demand management is such a difficult task in these rapidly changing times. To be fully successful policy measures must be geared mainly to conditions as they will be a year or more in the future. Policy changes which are geared to current conditions alone may prove to be inappropriate by the time they are having their full effect.

Finally, I would like to refer to the progress which has been made in developing the structure and improving the performance of Canadian capital markets. This has always been regarded by the central bank as a very important objective and we are also well aware, perhaps more so than most, of how much imagination, initiative, effort and risk-taking of so many people and institutions in the private sector have gone into it. I have just read a paper which Ed Neufeld gave a few days ago assessing the Canadian capital market as a whole, and am glad to know that he takes a favourable view of its range of facilities and its efficiency.

The performance of our capital markets has been of special importance in 1970 and 1971, when our current account balance of payments swung into surplus. This meant that there was no need for a net inflow of capital but instead for some net outflow. It was not easy to bring about such a change in capital flows because our guideline system limited net flows to overseas

countries and the low level of short term interest rates in the United States worked against flows into that market. In addition, Canadian borrowers had become accustomed to covering a substantial part of their requirements abroad and were hesitant about shifting too much of this borrowing to the Canadian market. In fact, however, a major shift has occurred, and it has taken place more smoothly than probably anyone would have predicted. Interest rate incentives to borrow in Canada rather than outside have been reasonably good and the Government and the central bank have encouraged Canadian borrowers to explore the domestic market very carefully before borrowing externally.

I can quantify the shift from external financing with a few figures. Net new issues of Canadian securities payable in foreign currency, which had risen from \$600 million in 1965 to \$1,700 million in 1969, declined to \$650 million in 1970 and to an annual rate of \$350 million in the first nine months of 1971. In earlier years net external financing had often accounted for one-quarter of total net new issues of Canadian securities, and in 1969 it accounted for more than one-third. In 1970 net external issues accounted for 11 per cent and in 1971 for 6 per cent of the total.

I mentioned earlier that monetary policy has given a high priority to avoiding interest rate incentives for inflows of capital. Another way of putting this would be to say that it has facilitated the adjustment of capital markets to a situation in which we did not need to borrow abroad on a net basis. This has been a difficult adjustment to make. The fact that Canadians were saving

enough in total to cover the over-all aggregate of Canadian borrowing needs did not necessarily mean that the flows of particular kinds of Canadian savings would automatically fit in with all the needs of particular Canadian borrowers, especially long-term borrowers. The matching-up process involved a rather large increase in financial intermediation between lenders and borrowers, which in the circumstances has seemed appropriate. Part of this increase in intermediation has taken place through the banking system and has thus contributed to the unusually large expansion of the monetary aggregates.

OT FOR PUBLICATION BEFORE 10.00 P.M. E.S.T. FEBRUARY 17, 1972

WORLD CURRENCY PROBLEMS

REMARKS BY R. W. LAWSON
DEPUTY GOVERNOR OF THE BANK OF CANADA
TO THE ECONOMICS SOCIETY OF ALBERTA
CALGARY, FEBRUARY 17, 1972.

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WORLD CURRENCY PROBLEMS

Those who are interested in world currency problems have had much to occupy their attention in recent years. There have been few periods in which some sort of crisis was not either present or impending. There have been several moments of high drama, but none seemed to me to be more dramatic than those in Washington last December. I am referring, of course, to the Smithsonian Agreement on foreign exchange rates and related matters that was reached on December 18 at a meeting of the Ministers and Central Bank Governors of the Group of Ten. That Agreement came at a critical juncture in international monetary history, and while it did not solve all the outstanding problems it did make promising emergency repairs to an international system that was threatening to disintegrate. It was therefore a very welcome development.

I am sure that you know the essentials of the agreement. The principal element was a new structure of exchange rates among the more industrialized countries, with the Japanese currency rising from its previous parity vis-a-vis the U.S. dollar by about 17 per cent, the German and the Swiss rising by about $13\frac{1}{2}$ per cent, the Netherlands and the Belgian by about $11\frac{1}{2}$ per cent, the British and the French by about $8\frac{1}{2}$ per cent, and the Italian and the Swedish by about $7\frac{1}{2}$ per cent. The United States Administration undertook to propose to the U.S. Congress an $8\frac{1}{2}$ per cent increase in the official U.S. dollar price for gold. It was agreed that the Canadian dollar would continue temporarily to float; at the time of the agreement it was floating about $8\frac{1}{2}$ per cent above its previous parity.

It was also agreed that it would be sufficient for the time being if the new exchange rates were maintained within margins of plus and minus $2\frac{1}{4}$ per cent rather than plus and minus 1 per cent by countries that so preferred.

The main purpose of these changes was to achieve a set of exchange rates which would call forth over time a better balanced pattern of world trade. Since it was the trade balance of the United States that was unsustainably weak, a relative decline in the value of the U.S. dollar was wanted. Since the trade balances of other countries were not all equally strong, the depreciation of the U.S. dollar was achieved by the appreciation in varying degrees of the currencies of other countries.

As part of the agreement the United States withdrew the 10 per cent import surcharge that it had imposed on August 15 and ended the discrimination against import content in the investment tax credit. The discussion of certain changes in trading arrangements that the United States was seeking with Japan, the European Economic Community and Canada was to be concluded before the devaluation of the U.S. dollar in terms of gold was proposed to Congress.* The convertibility of the U.S. dollar was left for future decision. I shall return to the question of convertibility later in my remarks, but first I want to look back to the state of affairs that produced the explosion of August 15.

To any who were following events at all closely, that explosion did not come as a great surprise. The pressure had been building up a long time, and some sort of an eruption was inevitable. The only questions were - when? and in what form?

The main sign of trouble was a rapid and persistent deterioration in the overall international payments position of the United States. That

* That proposal was in fact put before Congress on February 9, without an agreement on trading arrangements having been reached with Canada.

trend has given concern both in the United States and abroad for nearly a decade. It was, you will remember, in July 1963 - $8\frac{1}{2}$ years ago - that the United States first imposed the Interest Equalization Tax, and that step was not taken until there was convincing evidence that the situation was serious enough to warrant unusual measures. Its purpose was to strengthen the international account of the United States by discouraging foreign issues of securities in the U.S. market. In subsequent years various other steps were taken to moderate the outflow of capital, including restraints - first voluntary and then mandatory - on outflows of capital to U.S. controlled business abroad, and voluntary guidelines covering the outflow of loans and portfolio capital from banks and other financial institutions.

These measures helped the U.S. balance of payments on capital account, but the balance on trade account then began to weaken. The U.S. trade balance has declined sharply from a surplus of about $5 billion per year in the first half of the 1960's to a deficit of about $3 billion in 1971. While there are some differences of view as to what the target for the U.S. trade balance should be, almost everyone agrees that the present position is far too weak to enable the United States to play its proper role in the world.

If one asks why the trade and payments position of the United States has become so weak he will find that there are many elements in the answer.

I suppose that the most important single factor has been the rapid and continuous growth in the last 25 years of industrial capacity and know-how outside the United States. One thinks primarily of the rapid economic resurgence of the countries of Western Europe, and of the breath-taking

rise of Japan as an advanced industrial society. To any Canadian who has noted over time the changing sources of the manufactured goods that he buys it is obvious that the industrial power of the United States is not nearly as dominant today as it was a quarter of a century ago.

A good deal of the growth of manufacturing capacity and skills outside the United States has been the result of the initiative of U.S. multinational corporations. In the past public economic policy in the United States encouraged this sort of thing, but the balance of payments consequences of it have now given rise to second thoughts on the matter.

The trade in raw materials and primary products is also much less favourable to the United States than it used to be. As U.S. industrial output has risen, the richest and cheapest U.S. sources of many primary commodities have become depleted, and imports have risen rapidly. This is particularly striking in the energy field. At the same time, some types of agricultural products in which the United States is strongly competitive have encountered discriminatory treatment abroad, notably in the European Common Market.

Since 1965 inflation in the United States has been an important additional source of weakness in the U.S. trade balance. While the increase of U.S. prices as measured by the GNP deflator has not been higher on average than in European countries and in Japan, prices of U.S. exports appear to have risen considerably more rapidly than the prices of exports from those countries.

The war in Vietnam has also hurt the U.S. balance of payments. In addition to contributing to inflationary pressures at home it has given rise to large expenditures by the U.S. government in other countries.

Unfortunately the weakening of the U.S. trade balance has been accompanied in the last two years by weakness in the U.S. balance of payments on capital account despite the continuation of restraints on the outflow of capital. For internal reasons credit conditions in the United States have been much easier than in most other major countries, and this has encouraged large outflows of short-term capital from the United States to other countries, mainly via the Euro-dollar market. In the spring and summer of last year these flows in response to interest-rate incentives were supplemented by speculative flights from the U.S. dollar. Outside the United States it has for some time been a common view that the U.S. payments position would be considerably improved if U.S. monetary policy were more responsive to the country's external financial needs. Inside the United States, however, this goes against the grain because monetary policy is usually thought of only as an instrument for internal economic management.

What I have so far described as the trade and payments problem of the United States could be almost equally validly described as the trade and payments problem of the world since the counterpart surpluses to the large U.S. deficit are widely spread among the more developed countries. The less developed world is largely an innocent by-stander, but it is not unconcerned because the imbalance among the more industrialized countries is affecting all other international economic relationships, including the provision of capital for development.

Why, one may ask, was the present world-wide imbalance in trade and payments allowed to grow so large before it was seriously tackled? A large part of the answer lies in the fact that the principal deficit country, the United States, is also the source of the world's principal reserve currency, the U.S. dollar. The U.S. dollar is so readily accepted all over the world that most monetary authorities were willing to hold large amounts of dollars in their international reserves. In these circumstances financing for the U.S. payments deficit was available more or less automatically. Monetary authorities that acquired more dollars than they wanted to hold had the right to have them converted into gold by the United States, but for many years now this right has been exercised with great caution by the larger countries lest they put too much strain on the dwindling gold reserves of the United States and precipitate an international monetary crisis. Since the rest of the world was thus willing, even though in some instances reluctant, to add to its dollar holdings, the United States was not faced with the prospect of running out of means of international payment in the way that a country in chronic deficit usually is.

At the same time the central role of its currency made it more difficult for the United States to have the usual recourse of a country in chronic deficit to a reduction in its exchange rate. Depreciation of the U.S. dollar is possible only to the extent that other countries are prepared to accept an appreciation of their currencies vis-a-vis the dollar, and this is something they are usually reluctant to do. Several of the surplus countries had much larger surpluses than they wanted, and some complained that the U.S. deficits

were forcing inflation on them, but few of them showed much disposition either to appreciate their exchange rates or to do other things that would reduce their surpluses. Those of the surplus countries that were more willing to act were inhibited by the disposition of others to leave the initiative entirely to the United States.

One interesting view that emerged in the United States was that the United States should ignore its external financial situation, that it should follow a policy of "benign neglect" of its balance of international payments. The essence of this idea is that economic policy in the United States should concentrate exclusively on the domestic economic situation leaving other countries to adjust to whatever happens to the international payments position of the United States in whatever way they think best. However, when it became clear last August that the United States could no longer maintain the convertibility of its currency into gold, the U.S. Government rejected "benign neglect" and set about instead trying to organize an international solution to the problem.

While I did not believe that in the crunch the United States would opt for "benign neglect", I was nevertheless relieved to have evidence to that effect. I greatly fear what would happen in the rest of the world if the United States turned inwards and stopped trying to give leadership in international trade and financial matters. As a practical matter there is no other country or group of countries that is able to take on that role, and in the absence of leadership the world economy would very likely fracture into economic blocs. It would probably not then be long before the post-war

successes in freeing the channels of international trade would be reversed, and the world would be back trying to cope with the competitive exchange depreciations and restrictive trade practices that did so much harm in the 1930's.

The difficulties of preserving and strengthening the co-operative world economy are of course enormous. Until almost the end I was far from confident that an agreement on exchange rate matters could emerge from the recent meetings of the Group of Ten. As everybody knows, exchange rates are very sensitive matters both economically and politically, and it was not easy to believe that a group of Finance Ministers could negotiate them around a table. But they did. If there was one element more than another that contributed to the success of the effort it was that the Ministers shared a lively sense of what would follow if they failed.

So far I have been commenting on the world currency situation from the purely international point of view. Let me turn for a few minutes to looking at it as a Canadian.

For many years now the external economic environment has been favourable to Canada and it has tended to become increasingly so. There have, to be sure, been some unfavourable aspects, but on balance our foreign trade has developed rather well. Whereas during the 1950's and early 1960's Canada typically had a large deficit in its balance of international payments on current account, we appear now to have moved close to balance in our underlying current account position. Early in 1970, for a variety of fortuitous and temporary reasons, we actually moved into appreciable surplus on current account. Since we also had a surplus on capital account there was strong

upward pressure on the exchange rate and the Canadian dollar was permitted to float on June 1, 1970. Our exchange rate rose, and a higher value for the Canadian dollar is now contributing to the declining trend in our current account surplus.

The U.S. action of August 15 came to Canadians as a severe shock. Very large amounts of Canadian exports to the United States were subjected to a 10 per cent surcharge, and in some cases to discriminatory treatment under the new U.S. investment tax credit as well. In his statement President Nixon justified the surcharge by references to unfair treatment of the United States by other countries in respect of exchange rates and trading practices, and neither of these complaints seemed to fit Canada. In addition, there was a disposition by some U.S. spokesmen to attribute to Canada the counterpart of a major part of the weakness in the U.S. trade position. The implication of this seemed to be that Canada had an international obligation to return to large current account deficits financed by large inflows of foreign capital. This view was not acceptable in Canada, nor was it accepted by the International Monetary Fund or the Organization for Economic Cooperation and Development. Both of these organizations put Canada well down in the list of countries whose current accounts should weaken to accommodate the required adjustment of the U.S. position.

In these circumstances it was difficult for Canadians to keep the situation in perspective - to see that the United States was in deep balance of payments trouble and that a massive strengthening of the U.S. trade position was essential. There was a good deal of concern in Canada that the

United States had in fact opted in favour of economic isolationism, but fortunately this does not now seem to be the case. The continuing adverse trends in U.S. foreign trade do appear, however, to have nourished isolationist sentiment in the United States, and this is disturbing to us, whose interest lies in having beside us a United States that is internationalist, prosperous and relaxed. If the United States is inward-looking and feeling besieged, things are bound to be difficult for us. For that reason we in Canada have an especially strong interest in international initiatives aimed at helping to restore external economic equilibrium to the United States.

Now let me turn again to look more generally at some of the main world currency problems that still confront us.

Obviously the first priority is to achieve a satisfactory resolution to the present world payments imbalance. The new exchange rates will help enormously, but they must be given time to work. It will take two years, and possibly more, for their main effects to be felt. In the interval the underlying trends may be obscured for a time by cyclical and other shorter-term influences. Japan, for example, is at present in the trough phase of a business cycle, and the Japanese demand for imports is cyclically low. This will affect the Japanese trade position during 1972, and it will be hard to make a realistic assessment of the new foreign exchange value of the yen until the level of activity of Japan has risen appreciably.

There is another reason for caution in pre-judging the ultimate effects of the new exchange rates, and that is that much will depend upon what economic policies are followed in the surplus and deficit countries in

the interval. Exchange rate changes are only one of many influences that affect international payments positions, and what happens in other areas of public economic policy is also important. How the level of demand in a country is managed, how domestic costs and prices move, what sort of tax policies are followed, how much incentive there is for improved techniques of production - these all influence the way in which a country's foreign payments develop. In cases where countries are slow in achieving a desirable adjustment in their external payments, too little attention usually gets directed to the short-comings of their policies in these fields.

Let me return to the question of exchange rates. It is a widespread view among economists that insufficient flexibility of exchange rates is the main source of payments imbalances. Those who hold this view will presumably be encouraged by the new regime of wider margins, that is, plus and minus $2\frac{1}{4}$ per cent, which the IMF adopted as a temporary measure following the agreement of the Group of Ten. But some will think this change has not gone far enough, and that the arrangements should provide more room for exchange rates to float.

My only comment on this is to say that in my opinion the most important question for a government in respect of exchange policy is not should the exchange rate be "fixed" or should it float, but what should the exchange rate be? I am aware that some people seem to believe that if the exchange rate is determined in a free market without direct official intervention it will inevitably be the right rate, but this view seems to me to be a considerable over-simplification. A floating rate may be influenced indirectly

in a variety of ways to make it float freely at quite different levels. A decision to float does not therefore offer an escape from the fundamental question - what should the exchange rate be?

What exchange rate is appropriate for a particular country at a particular time is a hard question to answer. It involves a balance of conflicting considerations, some pointing to a higher rate and some to a lower. Unless the exercise is to be merely wishful thinking it involves taking full account of the policy measures that may be necessary to achieve any rate being considered. Good exchange rate policy is thus a blend of economics and politics; it requires analysis of the costs and benefits of the exchange rates that are possible in the circumstances, and then a choice between them. As a practical matter all that is needed is an idea of the range within which the exchange rate should lie in the existing circumstances.

One aspect of exchange rate policy that must be borne in mind is that it is an international matter. There is a tendency for people to think that each country's exchange rate is its own business. The trouble with that is that there are not enough exchange rates to go around; as in musical chairs, others can be accommodated without strain only if one participant is prepared to forgo his claim. If exchange rates are to be regarded as a sovereign right, who is to be the odd-man-out? Countries have in effect counted on the United States to play that role, but the United States cannot continue to do so because exchange rates are also important to it. There is no escape from the fact that exchange rates are genuinely international and must be dealt with as such.

One feature of recent events that is encouraging is that the quality of economic analysis that is available to governments in respect of exchange rate matters is improving rapidly. I am thinking here mainly of the work going on in the two principal international financial institutions, the IMF and the OECD. Economists in these organizations are developing new methods of analysis in search of internally-consistent solutions to international payments problems, and are giving better indications than were previously available of the choices that are available. The work is exploratory and the results are not precise, but it is reassuring that these matters are being tackled vigorously and imaginatively by groups with an international outlook.

Let me now come back to the international monetary arrangements themselves and consider how they may be altered in the near future.

As I have noted, we already have wider margins on a temporary and optional basis. All of the larger countries have opted in favour of them, and it is to be expected that an option of this kind will be incorporated in due course into the Articles of Agreement of the IMF. It thus appears likely that there will be somewhat more room for movements of exchange rates in the future than there was in the past.

It now seems probable that the Special Drawing Right will become the unit of measurement in the system. In that event currencies and gold will have their official values denominated in terms of SDRs. This will have little effect on the future role of gold in the system; its role is already being diminished by the creation of SDRs and the process will presumably go on.

There are major questions outstanding about the part to be played in the international system by the U.S. dollar. Everybody agrees that if a co-operative international system is to survive the U.S. dollar must sooner or later become convertible to some extent; the questions are to what extent, and by what procedures.

There are wide differences of view about how far it is necessary or wise to start by setting up a facility for the conversion into some other form - presumably into SDRs created for the purpose - of the U.S. dollars already in the hands of monetary authorities. Some people are strongly attracted by the logic of such conversion, and would go far in that direction. Others are much impressed by the practical difficulties that would be encountered, and would try to find ways of avoiding the conversion of outstanding U.S. dollar balances.

There is, however, general agreement that it is essential that future net increments of U.S. dollars to the total reserve holdings of the rest of the world are presented to the United States for conversion, and that the United States is willing and able to convert them. If the U.S. dollar does not become convertible to that extent, there will be no effective restraint on the growth of U.S. dollars in international reserves. This means that there will be no pressure on the United States to keep its balance of payments in order, and there will be no possibility of international control over the rate of growth of international liquidity. In such circumstances there would be little chance of maintaining an orderly co-operative world economic system.

Unfortunately it would be difficult for the United States to undertake at present any general obligation to convert net additions of U.S. dollars to

foreign holdings into other reserve assets. The reason is that the United States is still running a large deficit in its external payments and it has relatively small holdings of other reserve assets. Thus the pre-requisite for effective convertibility of the U.S. dollar is the restoration of equilibrium in the external payments of the United States. Only when that seems assured will convertibility become feasible. The actual procedures to be established to govern convertibility when it becomes feasible are largely a technical matter which, while complex, will be manageable.

In essence the problem of convertibility of the U.S. dollar is the problem of devising an international monetary system within which the United States is treated essentially the same as other countries. There is an element of artificiality in doing this because the United States is in fact not the same as the other countries involved - it is much larger, much richer, and economically much stronger. However, unless the United States is prepared to work within the same framework of international monetary arrangements as apply to others there is no chance of having a truly international economic system. For its part the United States seems disposed to take the international approach.

What we have recently been seeing, and what we shall continue to see, is the bargaining on the terms of these international monetary arrangements. It is slow and difficult work, not so much because of its technical complexity but because of the range and depth of the underlying issues. The United States thinks that other countries rely far too much on it, and that they are far too reluctant to share with it privileges that they claim for themselves, e.g., choosing exchange rates. The other countries think that the United States

takes advantage of its economic and financial power to expand its business investments abroad and to escape external financial discipline in the management of its internal affairs. There is a good deal to be said in favour of both sides, and it seems to me reasonable that both should want a better deal. Fortunately the major differences are not altogether irreconcilable, and it is possible to imagine the international system working in a way that would make all the participants happier. The problem is to find acceptable rules of the game that will encourage that outcome.

RECENT MONETARY AND CREDIT DEVELOPMENTS

Remarks by Gerald K. Bouey, Senior Deputy Governor, Bank of Canada,
at the Annual Meeting of The Canadian Mutual Funds Association,
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I was very pleased to receive the invitation extended by your Executive Director, on behalf of the Governors of your Association, to be here today.

The Canadian Mutual Funds Association is now marking the completion of its first decade of activity, and your industry its fourth since the first open-end mutual fund in Canada was established back in 1932. We in the central bank have followed developments in your industry with a keen interest, as indeed we follow all significant developments in the capital market. An efficient capital market is indispensable to an advanced economy. The mobilization and allocation of capital for the financing of the domestic economy, adjustments of our balance of payments position, and the smoothness and effectiveness of monetary policy in influencing credit conditions are all greatly dependent on the quality of our capital markets. Our institutions should facilitate financial flows through the economy and their practices should enjoy public confidence. Although the Canadian capital market is highly developed and, in my opinion, compares very favourably with capital markets of other countries, there is always room for improvement, room for adapting the various institutions in the Canadian market to the unique

requirements of the Canadian economy. I am conscious of the fact that your industry, like others, is constantly trying to improve its techniques and performance.

While I am interested in your industry, I do not presume to be able to deliver an address that would tell you something you do not already know about your own business. Instead I am going to try to tell you something about the business I am in, the business of central banking. I trust that you will find what I have to say will be of some relevance to your concerns, and I believe you will, because changes in credit conditions, that is, changes in the availability and cost of money, have widespread effects on all financial markets as well as on the economy generally.

My main purpose today is to bring up to date the account of how monetary and credit conditions have been developing in Canada. It is now two months since the 1971 Annual Report of the Governor was released and almost three months since it was written. I therefore welcome the opportunity you have given me to pick up the story and to give a rather informal report on what has been happening to credit conditions and on what the Bank of Canada has been doing.

There are three main points that I would like to stress. First, monetary policy has been strongly expansionary for over two years now and it must still be characterized as expansionary despite the rise in interest rates since the beginning of the year. Second, it has been expansionary because of the need to encourage economic growth and to reduce unemployment and industrial slack. Third, in pursuing an

expansionary monetary policy the central bank is not unaware of the inflationary dangers that could lie ahead if the liquidity of the economy were allowed to increase too rapidly as the amount of slack in the economy was taken up; the lags in the impact of monetary policy on the economy are long and it is therefore necessary to keep an eye on the prospective position of the economy one or two years hence as well as on the current situation. Our problem is to find the best balance between these shorter-run and longer-run considerations.

Monetary policy moved into an expansionary phase in the first quarter of 1970. This occurred after about a year and a half of special emphasis on efforts to help control the serious inflationary pressures that had developed.

Let me first review the broad sweep of developments over the last two years and then look more closely at those of recent months. In the two years since the first quarter of 1970, the Bank of Canada has followed a policy that allowed credit conditions in our economy to be relatively easy. The money supply, however defined, expanded rapidly. Interest rates came down sharply from the peaks reached in late 1969 and early 1970, although there have been some increases in recent months owing to the very strong demand for credit. The amount of financing through financial institutions and domestic financial markets has been very large.

Although the rate of growth in total bank assets has continued to be high, the character of the increase has changed markedly since the middle of last year. Up to that time the demand for business loans was

not particularly strong and most of the increase in bank assets involved an increase in the liquid assets of the banks, particularly Government of Canada bonds. Since mid-1971, however, the increase has been concentrated in bank loans and non-Government investments, which have grown very strongly, and on balance there has been very little increase in bank liquid assets. More simply, while the liquidity of the public as measured by its holdings of currency and bank deposits has continued to rise, the liquidity of the banking system has been reduced. This has not been an accidental outcome. Indeed, one objective of monetary policy in this period has been to keep bank liquidity under careful control.

Significant changes in the cost of money have also occurred over the past two years or so. From the high points reached in late 1969 or early 1970, long-term interest rates came down 1 1/2 - 2 percentage points to lows reached in early 1971 and again towards the end of the year. Short-term rates declined by 4 - 5 percentage points over the same period. But in 1972 bond yields and short-term money market rates have moved up again.

As I have indicated, the primary objective of monetary policy over the past two years has been to encourage economic expansion; a related objective has been to moderate the upward pressure on the Canadian dollar in foreign exchange markets. An unduly strong Canadian dollar hampers both our export industries and those domestic industries that must compete with imports. One of the factors that tends to increase the value of the Canadian dollar is a net inflow of capital. The relationship

of credit conditions in Canada to those outside can have an important influence on the flow of short-term funds and the volume of funds that is borrowed abroad through the sale of new issues of securities. The amount of this latter kind of borrowing in 1971 was considerably lower than in 1970 and very much lower than in 1969. This downward trend in borrowing abroad reflected the relatively easy credit conditions in Canada and was also influenced by the response of Canadian borrowers to requests -- which are still in effect -- by the Minister of Finance and the Bank of Canada to explore the domestic market very carefully before deciding to borrow abroad.

I believe that by bringing about relatively easy credit conditions and by having regard to the level of the exchange rate, monetary policy has made an important contribution to the economic expansion that we have been experiencing. It is not possible for me to disentangle with any precision the contribution of monetary policy from other policies and influences, including in particular fiscal policy which has also moved in an expansionary direction starting in the first part of 1970. The rate of growth of the Canadian economy since the third quarter of 1970 has averaged about 6 per cent in real terms, significantly above its average long-term potential. Unemployment has been slow to respond but on a seasonally-adjusted basis it dropped to an average of 6.0 per cent of the labour force in the first quarter of the year from an average of 6 1/2 per cent last year and a peak of 6.9 per cent last September. It was 5.8 per cent in April.

The growth of the Canadian economy over the last year and a half has taken place in an international environment that has not been as favourable as it might have been. The rate of growth of our major trading partners has been much slower than normal and to a considerable extent we have had to try to pick ourselves up by our own bootstraps. Our trading partners have been going through a period of relatively slow growth as a result of steps that they took to attempt to deal with their problems of inflation. In 1971 output in real terms (that is, after excluding price increases) in the United States rose by only 2.7 per cent. In the major countries of western Europe and Japan taken as a group, output in real terms grew by only 3 3/4 per cent in 1971 compared with an average of 6 1/2 per cent during the 1960s. However, the general expectation is that this group of countries, as well as the United States, will be moving into a period of significantly higher rates of growth than last year. If this turns out to be the case it will be of considerable help to Canada's economy in the period ahead.

The slow growth of our major trading partners has undoubtedly been an important factor in the movement of the current account of our balance of payments from a large surplus position to substantial deficit during the past year. Our exports have been growing slowly, indeed our exports to overseas countries declined sharply in the first quarter of this year, while imports continued to rise. The current account deficit in the first quarter of this year was of the order of $1 1/2 billion at annual rates, which is a long way from the surplus of over $1 billion we had in 1970.

I should, however, caution you that, given the structure of Canada's international trade, the current account balance tends to move in an irregular way and the first quarter figure I have just mentioned greatly exaggerates whatever decline there has been in the underlying position of our current account. Nevertheless, it seems that we have moved back to a position of substantial deficit. In comparing the present position with that of 1970 it is necessary to keep in mind a number of factors, including not only the fact that the growth of our trading partners and therefore their demand for the goods that we export has slowed but also that the Canadian dollar appreciated significantly in 1970, a change that was bound to take considerable time to have its full effect in the direction of reducing our trade surplus. Since May 1970 the Canadian dollar has appreciated by 9 per cent in terms of the U.S. dollar. However, when one takes into account the level of other exchange rates since the December 1971 realignment of currencies, the effective appreciation of the Canadian dollar since May 1970 is of the order of 6 1/2 per cent, calculated in terms of the currencies of the major countries with which we trade, weighted by the value of our bilateral trade with each one.

I would like to turn now to look more closely at monetary and credit developments in recent months, that is, 1972 to date. You can derive rather different impressions about these developments, depending on which of the available indicators you look at. If, for example, you looked only at interest rates, you would see a not insignificant rise since the end of the year. The average yield on long-term Government of Canada

bonds has risen from a low of 6.50 per cent last December to about 7.35 per cent. Long-term yields have tended to stabilize in the last month or so. Short-term and mid-term bond yields have also risen substantially since the beginning of the year. Mortgage rates have moved up much less than bond yields. Increases in interest rates have been particularly marked in the money market where strong competition by banks for funds has pushed rates on bank certificates of deposit from around 4.4 per cent in January to over 6 per cent; rates on commercial and finance company paper have kept pace. Over the same period the Canadian dollar has strengthened in the exchange markets. And you might wonder why this has happened in an economy where it is generally believed that there is considerable slack, where unemployment, though it has come down, is still high.

However, if instead of looking at interest rates you were to choose another set of statistics, those which describe the trend of bank loans and the monetary aggregates, you might obtain a quite different impression of monetary and credit developments. You would find statistics such as the following for the first four months of 1972, seasonally adjusted at annual rates:

Increase in:	general loans	28 per cent
	total bank assets	21 per cent
	total currency outside banks and chartered bank deposits	18 per cent
	privately-held currency outside banks and chartered bank deposits	25 per cent

Those who concentrate on this kind of information might become concerned that increases of these magnitudes indicate that monetary policy may be overdoing things on the expansionary side.

This situation -- a rise in interest rates accompanied by unusually high rates of growth in the monetary aggregates -- has created something of a dilemma for monetary policy. But before dealing with that I want to stress that the figures I have just cited create an exaggerated impression of what has been happening because of some switching of financing into the banking system from other sources, as well as some switching in investors' portfolios into short-term claims issued by the banks from non-bank short-term claims. Competition among the banks for large blocks of short-term funds has pushed the rates paid on them to over 6 per cent. Since this is close to the rate charged on their loans from banks, many borrowers have allowed their paper to run off at maturity and have relied instead on bank loans. Other financial institutions that issue short-term claims have also been affected. This process, taken by itself, increases the volume of both bank loans and bank certificates of deposit outstanding but, if you look through the statistics, it does not reflect any change in the amount of either total financing or total liquidity in the economy. If present interest rate relationships persist, it will continue to be necessary to look through these statistics in order to appreciate the underlying position. I might say in passing that this situation raises questions about the way in which certain interest rate relationships work out in our system, but I do not want to go into that subject today. If allowance were made for this switching into the banking system, the rates of increase in the statistics that I have mentioned would be significantly lower -- perhaps 7 - 8 percentage points should be knocked off the annual rate of growth of

general loans in the first four months of 1972 and at least 4 percentage points in the case of total bank assets. The adjusted rates of increase would, however, still be high and the dilemma to which I have referred -- a significant increase in interest rates on the one hand and rapid monetary expansion on the other -- would still be there.

The choices that confronted the central bank in the first few months of this year were not ideal by any means. One choice might have been to attempt to prevent, or significantly limit, the rise in interest rates that has occurred by following an even more expansionary policy, that is, by allowing liquidity to grow even more rapidly than it has grown. This is not to say that the attempt would necessarily have been completely successful because interest rates, especially long-term rates, are influenced to a very important extent by expectations which could well have been adversely affected by even larger increases in bank deposits. Another choice could have been to attempt to hold the increase in the money supply to a much lower figure and to tolerate sharper increases in interest rates, and presumably more appreciation of the Canadian dollar, than has in fact occurred. As you can see, the path that was chosen lies between these two alternatives. I believe it has been a reasonable choice.

As I have already indicated, the dominant factor in our financial markets for some time has been the very strong demand for credit, particularly for business loans from the banking system. Bank loans to consumers have been strong since mid-1970. They increased by 24 per cent in 1971 but slackened off to an annual rate of 15 per cent in the first

quarter of this year. Business loans did not pick up strength until about a year ago but in the nine months ending in March 1972 rose at an annual rate of 33 per cent. To some extent the strength of business loans has reflected the extension of bank interest into the term loan field, more bridge financing of construction, and apparently more recently the financing of more business inventory accumulation. The growth of business loans in 1971 was not primarily the result of a switch to the banking system from other sources. Total business credit from all sources rose at a rate that was very high in relation to the growth in economic activity and it appears necessary to assume that there had been some considerable accumulation of financial assets by business corporations in order to account for all of it. Though this may have continued in 1972, the substitution of bank loans for commercial paper and bankers' acceptances, for new issues in the bond market, and for borrowings from other sources, seems to have increased in importance.

Looking to the future, and taking into account not only the fact that prices and costs continue to rise more quickly than we would like to see but also the long lags in the effects of monetary policy on the economy, the Bank of Canada has felt it necessary to keep the high rate of expansion of the banking system that occurred in the first part of 1972 from being even higher. It has done so by keeping a tight hold on bank liquidity. The liquid assets of the banks have declined since December. The ratio of "free" Canadian liquid assets, that is, liquid assets over and above the statutory

requirement, has declined from a peak of 16.5 per cent of total assets in April 1971 to 15.2 per cent in December 1971 to 13.9 per cent in April. The banks have reacted to the strong demand for bank loans and to this tight rein on their liquidity in three major ways. First, they have reduced their holdings of Government of Canada bonds by about $300 million since December. This has been one of the factors in the increase in bond yields that has occurred despite large purchases made by the Bank of Canada in order to cushion the impact on yields and despite the retirement of some Government debt in that period. This decline in the banks' holdings of bonds has more than accounted for the net reduction in their Canadian liquid assets. Second, the banks have reduced their net foreign assets by over $400 million since December. Third, the banks have competed particularly aggressively for large blocks of short-term funds -- their non-personal term and notice deposits have risen by $2 billion since December and, as I have noted, rates on short-term paper have risen sharply.

The very strong pressure for credit has had an influence not only on interest rates but also on the exchange rate by giving rise to an inflow of short-term capital, particularly in the early months of this year. The fact that the Canadian dollar strengthened in a period when the current account of our balance of payments was weakening appears to be due in considerable part to this factor, although there are a great many other transactions that affect the exchange rate.

To return to the alternatives that confronted the Bank of Canada in the first part of this year, it is probably not very useful to say

that we would have preferred a different set to choose from. You would not expect me to try to predict how much the range of choices can be expected to change in the period just ahead. However, when you look at some of the various factors affecting the demand for credit, including the outlook for investment expenditures and the possibility that the buildup in corporate liquidity may not continue, and the factors on the supply side, including the trend of retained earnings, it is not clear that we should necessarily expect a tight fit in credit markets. Much will continue to depend on investors' expectations and on the development of credit conditions outside Canada. But in recent months, given the strong demand for credit, a choice that would have permitted for that particular period both a more moderate rate of expansion of the money supply and less upward pressure on interest rates was simply not available. The laws of supply and demand are no easier to avoid in financial markets than in other markets.

To sum up, although the Bank of Canada has kept a tight hold on bank liquidity so far this year, and although interest rates have risen, I see no reason today to describe monetary policy differently than it was described by the Governor of the Bank of Canada in his recent Annual Report:

> "It continues to be the objective of the Bank to encourage sustained economic expansion and a reduction in unemployment in Canada, and to ensure that this objective is supported by an adequate degree of monetary expansion. We continue also to be mindful of the risks of inflation that would be involved if we approached the zone of full utilization of our resources with an excessive amount of liquidity in the economy."

NOT FOR PUBLICATION BEFORE 1:30 P.M. EASTERN DAYLIGHT SAVING TIME,
APRIL 30, 1973

WHAT CENTRAL BANKING IS ABOUT

Remarks by Gerald K. Bouey, Governor, Bank of Canada
to The Canadian Club of Toronto
April 30, 1973

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Some of you may recall that last autumn, after having accepted an invitation from your President to speak to members of your Club in the latter part of November, I subsequently asked for a postponement. A number of events of some note occurred between the date of my acceptance in August and the scheduled date in November, but the relevant one in this connection was Mr. Rasminsky's decision to retire as Governor of the Bank. The topic I had planned to use was "What can be expected of monetary policy", and suddenly I felt more like asking the question than trying to answer it. Your President was most understanding. After my appointment on February 1st he renewed the invitation and I promised to show up this time. Today I would like to say something about the way I look at central banking and in the course of doing so refer to some recent events.

Anyone taking on a job like mine is bound to notice something all too familiar about the list of major economic problems which, he is told, demand his urgent attention. The level of unemployment, the trend of prices, international monetary and trade uncertainties -- surely such a list must be an out-of-date one prepared several years ago for a predecessor.

Unfortunately, the truth is that the problems central bankers have to worry about these days, whether in Canada or in other countries, are still the same hardy perennials. It's not much easier than it ever was for public policy to keep the economy expanding steadily along a satisfactory growth track. There are risks of falling off on either side -- into inadequate growth and rising unemployment on the one hand, into worsening inflation on the other -- and those concerned with economic policy must try to weigh these risks as best they can, knowing that the problems are not of a kind that yield to once-and-for-all solutions.

This is not the only reason why a new governor is likely to feel some trepidation. While in some quarters central banks once appeared to enjoy a quite undeserved reputation for omniscience, the opposite view -- that both the motives and the competence of central banks should be regarded with suspicion -- seems to have gained ground in recent years.

Up to a point, of course, it is possible even for a central banker to regard this shift in public opinion as a welcome move in the direction of realism. After all, there is no reason why those of us whose jobs involve us in the management of the nation's monetary affairs should not be expected, like anyone else, to be able to offer reasonable explanations for our actions.

On the other hand, some of us do find it a little difficult to recognize ourselves in the more extreme caricatures

of central bankers that seem to be in vogue these days. Perhaps an illustration or two might help to make the point.

Some critics seem to believe that the typical central banker combines a pathological obsession for fighting inflation with a heartless disregard for the plight of the unemployed. This is alleged to be reflected in an habitual foot-dragging attitude toward monetary expansion together with continual harping on the evils of inflation.

Others suspect just the opposite -- that in spite of much sanctimonious preaching against inflation central banks are in fact prime culprits in fuelling the process. Their record over the years is cited as proof that central banks can be counted on to permit a rising tide of money to finance chronic inflation, whether in response to the insatiable financial demands of governments or because of their own anxiety to avoid unpopularity.

Still others, conceding that central banks probably mean well, judge them to be merely incompetent and vacillating. According to this view, at the slightest rise in the inflation rate they jam the money tap tightly shut, and are quite surprised when this has no immediate effect on prices; later on, when the unemployment rate begins to rise, they not only fail to recognize this as being a predictable lagged effect of their own actions, but try to correct it by going to the other extreme and flooding the country with money. In this view central bankers, like the Bourbons, are incapable of learning anything from experience.

Without going so far as to claim that these caricatures are totally inaccurate, I do think that they reflect a less than perfect understanding of the problems faced by a central bank in a modern society.

Let me begin with a word about what I take to be the ultimate objectives of monetary management. My view, which is in no way new, is that the objectives of monetary policy are the same as those of public policy generally. Not only would it be presumptuous of the central bank to try to impose different goals of its own on the community, but it would also be quite unacceptable in a democratic country.

Among the most important objectives of public economic policy are sustained economic growth, high employment -- that is to say, low unemployment -- and reasonably stable price behaviour. These are difficult goals to achieve all at the same time, but I don't believe there is any major quarrel about them in our society. The real arguments are about what is the best strategy for achieving these objectives, and about how long a time horizon one should have in mind in weighing the consequences of alternative policy approaches.

What contribution can monetary policy make towards the achievement of these goals? We can skip the technicalities -- open market operations, cash reserve management, changes in secondary reserves and in the Bank Rate. The important thing is that the central bank is a public agency with certain

technical powers at its disposal, and that these powers enable it to influence credit conditions by controlling the rate of growth of the nation's privately-owned banking system.

There are two main reasons why the operations of the chartered banks have an important bearing on the functioning of our economy. The first is that bank loans and bank purchases of securities are among the major sources of financing in Canada. The second is that as a by-product of these transactions, the public comes into possession of deposit balances in bank accounts, which serve as much the most important form of money in this country.

Over the years, the amount of credit extended by the chartered banks and the amount of money in the hands of the Canadian public have grown hand in hand. At times the growth of bank credit and money holdings has been allowed to proceed quite rapidly, and at other times much less rapidly, depending on discretionary judgments of the Bank of Canada as to how to exercise its technical powers in particular situations.

The effects of these policy choices show up in various ways. The most immediate effect of a rapid rate of monetary growth is that for a time it brings about easier credit conditions than would have prevailed with slower monetary growth. The cost and availability of credit throughout the financial system are, of course, also importantly affected by changes in the underlying economic situation and in the related strength

of credit demand in Canada, as well as by changes in credit conditions in other countries.

The ability of the central bank to influence credit conditions in Canada has further ramifications, since changes in the relationship between Canadian and foreign interest rate levels can affect flows of funds between Canada and other countries and can therefore affect the exchange rate for the Canadian dollar.

Of course it is not just conditions in financial markets that are influenced by Bank of Canada actions in permitting a faster or a slower rate of domestic monetary growth. The ultimate effects of the monetary policy followed -- and much the most important ones -- are felt in our markets for goods, services and labour. There is an important connection -- though by no means an immediate or very precise relationship -- between the growth of the banking system and the growth of money expenditure in the economy. It is this flow of money expenditure, of course, that enables production and employment in Canada to grow. But it is also this same flow of money expenditure that enables prices, wage rates and other money incomes to rise at the rates they do.

Monetary management is not, of course, the only influence affecting the over-all level of spending in the economy, nor is it necessarily the dominant influence. In addition to private decisions, the policy actions

of governments at all levels directly affect aggregate spending in Canada through decisions taken with respect to expenditure, taxation, lending and borrowing, and so do economic and financial conditions in other countries. Major ups and downs in economic activity in Canada have always been closely related to those in the United States. One does not have to believe, however, that monetary policy is all important for the functioning of our economy in order to believe that it is nevertheless important enough to try to get it right.

So much for the nature and broad effects of the powers the central bank has to work with. How are these powers to be used in practice? This takes me back to the beginning of my remarks, where I implied that the job of a central banker is essentially a balancing act. Bearing in mind the impact of other domestic policies and of economic conditions in other countries, he wants to ensure that the banking system keeps growing at a rate high enough to enable the economy to reach -- and to stay on -- a sustainable path of vigorous growth at high levels of employment. On the other hand, he wants to avoid a rate of growth of the banking system so rapid that at some stage it will become virtually impossible to contain inflation while at the same time maintaining satisfactory employment growth.

In an economy suffering from abnormally high unemployment and much idle plant capacity, the main response to a strong rise in spending usually takes the form of more jobs and

more output rather than a more rapid rise of costs and prices. If the growth of jobs and output is rapid enough and lasts long enough, however, in due course a stage will come where growing scarcities of the right kind of labour in the right places, together with spreading production bottlenecks, progressively alter the form of this response. In circumstances such as these; an overly rapid growth of money expenditure is increasingly likely to have as its main result a marked escalation of cost and price increases rather than further large gains in employment and output.

Indeed, if the process is allowed to continue, a point will eventually be reached where further postponement of policy measures to check the pace of spending growth in order to contain inflation will no longer be possible. Past experience in many countries shows that an unfortunate by-product of belated action to cope with a situation of this kind -- once it has been allowed to get out of hand -- can be a sharp slowing of economic growth and a substantial rise in unemployment. For this reason, I believe there is an important sense in which it can be said that a worsening of inflation often leads in time to a worsening of unemployment.

The operating decisions that have to be taken by the central bank necessarily involve difficult judgments about whether credit conditions are suitable, and about the degree to

which the rate of growth of the banking system should be speeded up, slowed down, or maintained approximately within its existing range. Such judgments have to be made on an assessment of probabilities rather than on certain knowledge. For this reason they are bound to be provisional and subject to modification as new information and unexpected developments alter the balance of future probabilities.

An essential ingredient of judgments of this kind is an informed view not only about how the economy has been moving in the recent past and where it stands now, but also about the possible paths it might follow over periods as long as two years or more into the future under alternative policy assumptions. The need for such a long forward view about where the economy seems to be heading is a consequence of the long time lags that exist between monetary management today and its eventual impact on the future course of economic events.

Perhaps I can best illustrate the way in which the Bank of Canada approaches the decisions it has to take by outlining very briefly the basic rationale of recent monetary policy.

During 1972 the Bank of Canada permitted a further large increase of 15 per cent in the over-all size of the domestic banking system, following a 19 per cent increase in the previous year. Thus over the past two years we have had

sustained monetary expansion at rates not only on the high side in relation to past Canadian experience but also distinctly higher than the recent growth rate of aggregate spending and income.

The dominant consideration underlying this expansionary policy was the obvious need for large increases in demand, output and employment for some time if the Canadian economy was to regain more satisfactory operating levels. In seeking to maintain relatively easy credit conditions, the Bank also had in mind the potential drag on economic expansion of an undue appreciation of the Canadian dollar in foreign exchange markets if too much foreign capital moved into Canada.

While giving priority to the immediate objective of reducing the margin of slack in the economy, the Bank has not been unaware of the time lags involved in the operation of monetary policy, and for some time now it has kept the liquidity of the chartered banks under close control. When the already high rate of growth in bank loans became even higher in the first three months of this year, reaching an annual rate in excess of 25 per cent, the Bank of Canada did not permit the whole of this loan expansion to be accommodated through a correspondingly faster rate of monetary growth. The resulting pressure on the liquidity of the domestic banking system, together with recent substantial increases in short-term interest rates in the United States and overseas, were the main factors that led to the recent

rise in short-term interest rates in Canada, including the increase in the Bank of Canada's own lending rate.

Since a change in our Bank Rate tends to focus attention on the stance of monetary policy, I want to spend a few moments in an effort to explain as clearly as I can what our current policy is intended to achieve.

As I emphasized at the time of the Bank Rate change, substantial rates of bank loan and monetary expansion continue to be needed in order to finance vigorous growth in output and employment. There is ample evidence that the pace of economic growth in Canada since the third quarter of last year has been unusually rapid, and that we are well on our way towards the restoration of high levels of employment. Prospects that the current vigorous expansion will continue are good. There are, for example, clear signs that the pace of capital spending by Canadian business will be accelerating in the period ahead, and strongly rising demand for our exports will be an additional source of stimulus.

Looking even further ahead, however, it must be recognized that the current rate of growth in aggregate spending is too high to be sustainable over the longer run. If the economy has too much momentum when it eventually begins to bump up against its capacity limits once again, we risk a period of temporary overshoot followed by another period of

slack. To guard against this danger, what will be needed at a later stage is some moderation of the rate of growth of spending.

The recent pace of bank credit extension has clearly been too rapid. Part of the increase in the demand for bank credit appears to have come from foreign corporations, which at present have an interest rate incentive to raise funds in Canada either for use abroad or to replace funds that would normally be obtained abroad. The effective interest rate paid for bank credit by large prime borrowers in the United States is currently about 8 per cent (after allowing for the widespread practice of requiring compensating deposit balances) as compared with $6\frac{1}{2}$ per cent in Canada. In view of this situation, the Bank of Canada has asked the banks to give priority in the use of their total loan resources to the credit-worthy demands of their Canadian customers rather than respond to unusual requests of the kind I have mentioned from foreign corporations or foreign-owned subsidiaries in Canada. In addition, the banks have been asked to pay particular attention to the needs of small businesses, which do not have easy access to other credit sources, and to applications for credit in the slower growth regions of the country.

I want to stress again that we are not moving to a tight money situation and that the banking system will continue to be in a position to accommodate reasonable growth in the total amount of bank lending.

I hope you will bear with me if, in concluding, I reemphasize three main points.

The first is that there are long time lags in the response of the economy to monetary management. It is true that some effects may be felt relatively quickly, but on the average the time that elapses before output and prices are affected is relatively long. Why would the Bank of Canada raise the Bank Rate when the latest unemployment figure available at the time was still as high as 5.9 per cent? (It has since come down to 5.5 per cent.) The answer is that the Bank must not only keep in mind current developments but must also look ahead to the likely situation next year and the year after.

The second point is that the demand for credit, the growth of the banking system, and the level of interest rates are all interrelated. To insist that a central bank maintain any particular level of interest rates is to insist that it abandon control over the growth of money and credit. This may seem to be an elementary point, but I sometimes have the impression that the central bank is expected to avoid both a rapid increase in the money supply and higher interest rates regardless of the strength of the demand for credit.

Finally I want to reject totally any suggestion that the Bank of Canada is somehow more concerned with price indexes than with people. As I have already stated, the Bank

remains firmly committed to maintaining rates of monetary growth high enough to support a strong expansion of employment and output. But for monetary policy to go even further and promote excessive spending that will speed up the pace of inflation -- inflation which in turn must eventually be brought under control with serious risk of adverse effects on employment and growth -- is not my idea of the way to advance the cause of human welfare. We will do better over the longer run in terms of employment as well as in terms of our price and cost performance if we try to avoid such excesses.

Recent experience has shown how difficult it is to deal with the aftermath of periods of excessive spending through demand management policies, once inflationary expectations have become very strong. This is not, however, an argument for failing to take the necessary measures to avoid getting into such a situation in the first place.

The Bank of Canada is going to continue to pay close attention to the problem of unemployment. At the same time -- although I acknowledge that living as we do in a sea of world-wide inflation greatly limits the possibilities for achieving as good a price and cost performance as we would like to see -- the Bank is not going to forget about the problem of inflation.

There are many more settings on the dial of monetary policy than the extremes of very easy money and very tight money, although we seem to lack an adequate vocabulary for describing the intermediate points. The best chance of getting our policy setting right is to try to strike a reasonable balance between risks that lie ahead on either side -- the risks associated with too much monetary expansion or too little. But that, after all, is what central banking is about.

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OT FOR PUBLICATION BEFORE 9:15 A.M. EASTERN DAYLIGHT SAVING TIME
JUNE 11, 1973

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE ANNUAL CONVENTION OF THE
INVESTMENT DEALERS' ASSOCIATION OF CANADA
QUEBEC CITY, JUNE 11, 1973

Remarks by Gerald K. Bouey, Governor, Bank of Canada
to the Annual Convention of the
Investment Dealers Association of Canada
Quebec City, June 11, 1973

I am very pleased to have the opportunity of speaking to a group of investment dealers from across Canada quite soon after my appointment as Governor. The occasion is particularly pleasant because your invitation brings me to one of my favourite cities, Quebec, if only very briefly. I should very much like to stay here with you and to join in your discussions, but unfortunately I am not able to do so.

I plan to use much of my time today to speak of the way in which monetary policy is developing. Before taking up that topic, however, I would like to compliment M. Charron and Mr. Kniewasser on the organization of this Convention and on the choice of the future of your industry as its general theme. We in the central bank need good financial markets in which to implement monetary policy and perform our role in the management of the Government's debt. More generally the country needs a healthy capital market in order that savings can be channelled efficiently into the investment that is required to sustain vigorous economic growth. Your role in the development of such a capital market is vital.

You will be examining the future of your industry. The pace of change is such that I am sure you will not lack for topics. It is a bit startling to look back over even a relatively short span of years and

take stock of the changes that have taken place in Canadian capital markets. Your own business has become a great deal more varied and complex than it was, as new activities have been added to your basic function in the markets for equities and longer-term debt. Foremost among such developments, one thinks of the money market. From a modest beginning, nurtured by the Bank of Canada, it has grown to occupy a place of great importance in the financial system. Some twenty years ago Government of Canada short-term bonds and Treasury Bills were the principal instruments available to that market. Now there is in addition a great array of provincial and municipal notes and bills, bankers' acceptances, chartered bank bearer notes, corporate and finance paper and an expanding supply of short-term bonds. And with this growth has come the development of many new techniques of inventory financing -- day loans, special call loans, buy-backs, off-street loans, and so on. There is no need for me to remind a group of investment dealers of the degree to which your industry has contributed to these developments, or of the extent to which the healthy and efficient operation of the money market depends on your skill and vigilance.

The extraordinary growth of links between national financial markets has provided another dimension to developments in Canada. International capital flows are nothing new for Canadians and certainly the arrangement of international investments is not a new activity for investment dealers. The growth of international markets has, however, opened up opportunities on a new scale. At the same time it must be admitted that

international business can involve new risks for the participants and that it has added at times to difficulties in managing our affairs.

There have been striking changes also in other parts of the financial system. Most dramatic, perhaps, are those affecting the position of individuals and households. The growth of Canada Savings Bonds, to which the sales efforts of investment dealers have contributed greatly, is only one example of the enlargement of investment opportunities now offered individual Canadians compared to what was available in earlier years. There is now a much wider choice of deposit instruments at banks, trust and loan companies, caisses populaires and credit unions. One thinks also of mutual funds, of new types of insurance and annuity contracts and of the spread of private and public pension arrangements.

On the other side of their balance sheets, individual Canadians as borrowers also have more options open to them. Twenty-five years ago the consumer credit business was still in its infancy. Since then as more lenders have entered the business, the spread of the new lending techniques has enormously widened the access of consumers to credit. There has been a revolution of comparable importance in the market for residential mortgages. Among the major steps have been the spread of regularly amortized mortgages, the entry of government agencies as mortgage lenders and the provision of mortgage insurance, first by C.M.H.C. and more recently by private insurers. As a result of these changes there has been a significant widening of access to mortgage funds.

A full account of the new features of our financial system would take a long time. Private financial institutions have grown in number and in the variety of their borrowing and lending activities. Deposit insurance through government agencies affords protection for the public over and above that provided by careful supervision and inspection. In addition to the private institutions, we now also have a considerable range of governmental bodies contributing in their various ways to the financing of such sectors as housing, small businesses, and farming -- areas where it has been felt that governments could usefully complement the work of private institutions and markets.

In this context I want to make special mention of the Industrial Development Bank, which as you know is a subsidiary of the Bank of Canada. It is perhaps not generally recognized how rapidly the I.D.B. has expanded its operations in seeking to help the development of small and medium-sized business in all parts of the country. Its loan approvals have more than doubled over the past five years as have its total assets -- to almost $700 million -- and the number of its branches has increased from 28 to 48. The I.D.B. is now a large de-centralized financial institution, equipped with a highly qualified staff who operate in a business-like way in the specialized area of term financing.

The developments of recent years have brought new challenges for investment dealers. The industry has responded by developing greater expertise, expanded research facilities, more efficient administrative

techniques. Changing circumstances have called for consideration of such questions as the optimum size of firms and their capitalization, foreign ownership, fee structures, and regulation both by government bodies and by the industry itself. And of course the challenges are not likely to be less than they have been. For example, major energy and natural resource investments will call for skilful and imaginative financing. To take only one other foreseeable development, the computer is bound to have a major impact not only on the payments system but on the financial system generally. In this regard, I am impressed by what I have heard about the progress your industry, in co-operation with others, is making towards the development of a central depository system for securities.

These will no doubt be among the topics you will be covering and I wish you well in your discussions.

The changes of recent years have affected our business in the central bank as well as yours as private participants in financial markets. However, just as the essentials of your job remain the same, so do the essentials of ours. You try to bring savers and investors together as efficiently as you can. Our job is to regulate the pace of monetary and credit expansion in Canada in such a way as to help the economy achieve and maintain vigorous growth and high levels of employment. This means avoiding, insofar as possible, the waste of high unemployment on the one hand and the strains of worsening inflation on the other. It will come as no surprise to you that this is more easily said than done. There are a

few things I'd like to say about the monetary policy we have followed in the changing economic circumstances of recent months.

At the beginning of the 1970s monetary policy in Canada faced a task which could be thought of as comprising two stages. The first stage of the task would be to help get the economy expanding rapidly enough for long enough to carry it back up to relatively high levels of employment and capacity utilization. Once this objective was in sight, the task would change to one of helping steer the economy onto a sustainable expansion path without inflationary over-heating, and keeping it on this path of high employment growth.

Thus in 1971 and 1972 the monetary policy followed in Canada was strongly expansionary. Its main objective was to help stimulate the unusually rapid gains in spending, output and jobs needed to bring the economy back up to more satisfactory operating levels as soon as possible. The chartered banks were provided with sufficient growth in their cash reserves to enable them not only to accommodate all normal credit demands without significant strain, but also to conduct an aggressive search for additional lending opportunities.

As a result the supply of bank credit in the form of loans, mortgages and similar investments registered substantial increases of 21 per cent in 1971 and a further 23 per cent in 1972. Although the banks were not able to add commensurately to their holdings of liquid assets from mid-1971 onwards, their overall asset growth nevertheless amounted

to 19 per cent in 1971 and 15 per cent in 1972. In total, private holdings of currency and chartered bank deposits registered increases of much the same order of magnitude during this period.

For a time the response of the economy to this rapid growth in money and credit and to the expansionary measures introduced by the Government was less vigorous and clear-cut than one would have liked. As recently as the third quarter of last year, there were signs of at least temporary hesitancy in the pace of expansion, and the absence of any significant downtrend in the unemployment statistics was particularly disappointing.

Since the autumn of last year, however, the tempo of economic activity in Canada has picked up dramatically. Whatever lingering doubts there may have been about the underlying strength of the current expansion have been dispelled by the impressive economic advance since last fall. The extraordinarily rapid rates of increase in output that occurred in the fourth and first quarters were in part a catching-up after the strike dislocations which plagued the economy earlier. But if one compares the current level of major economic indicators with their levels a year ago, the record is still a remarkable one. Let me give you a few of the numbers. (These comparisons are based on the increase over the year to the most recent three-month period available.) The Gross National Product has risen by 13 1/2 per cent in value and by 8 per cent in volume. Industrial production is up by 9 1/2 per cent. These increases are in fact

as large or slightly larger than the impressive gains recorded by similar measures in the United States over the same period. Among the major sources of demand, total consumer spending has increased by 13 per cent with spending on durable goods up by 22 per cent. Both our exports and our imports have increased by nearly 25 per cent. The strong gains in demand over the past year have also had a substantial impact on employment, which in February, March and April was almost 5 per cent higher than a year earlier. Moreover, the gains in employment over the past year have been substantial in all parts of the country, with the largest occurring in the Atlantic provinces and here in Quebec, where the increases were 6.3 and 5.2 per cent respectively. While the very strong demand for labour has been accompanied by an exceptional growth of the labour force, it has finally brought a significant reduction in the national unemployment rate -- from 6.9 per cent in September to 5.5 per cent in March and 5.4 per cent in April. This is a most welcome development.

The recent acceleration of activity in Canada has brought us a good deal closer to the effective capacity limits of the economy than we have been for some time. While the overall unemployment rate is just below 5 1/2 per cent, the rate for men 25 and older has come down to 4 per cent, only about 1/2 of 1 per cent higher than the level for this group in the mid-1960s. Indeed there is already evidence of distinctly tight conditions emerging in the labour market for experienced workers in various regions of Canada. Moreover, order backlogs have increased and delivery dates lengthened in the case of a number of important basic

materials, such as lumber, cement and certain steels, chemicals and paper products, as output in these industries nears capacity. I am well aware that the situation in both labour and product markets is by no means uniform across the country, and in assessing the situation we must continue to bear in mind regional disparities.

To date most of the increased price pressures that we have been seeing can be attributed to developments in international markets, where there has been an almost unprecedented rise in the prices of many basic foodstuffs and other primary commodities. We need to be alert, however, to the risk of adding to these externally generated pressures by allowing domestic demand to move up so rapidly that we become faced with generalized strains on our productive capacity.

The rate of growth in real GNP during the two quarters ending 1Q 1973 was close to 12 per cent a year on the basis of the preliminary estimates now available -- more than double the 5 - 5 1/2 per cent a year that is generally regarded as the maximum growth rate sustainable over the longer term in this country. It is true that a number of measures of economic activity such as automobile sales, housing starts and inventory accumulation appear to have reached such high levels that some pause in their upward climb seems very likely. Nevertheless, such forward-looking indicators as the survey of investment intentions and new orders for manufactured goods suggest that we can expect further strong growth in output and employment.

In the United States the economic expansion is also well advanced. By the early months of 1973 the rise in employment had brought the total unemployment rate down to 5 per cent and the rate for adult men in the labour force down to about 3.4 per cent. The recent emphasis in U.S. economic policy has reflected concern that the expansion is proceeding too rapidly and that the stage has been reached where further increases in demand at the same rate would add to inflationary pressures in product and labour markets and make it more difficult to avoid a subsequent letdown.

It has become popular in the United States to speak of the problem facing that economy as one of "re-entry". There is widespread recognition that the problem now is to moderate the pace of expansion so that the economy can grow at the rate needed to maintain high levels of activity and employment. An economy growing much more rapidly than its long-run potential growth rate must slow down sooner or later. The important question is how smooth this adjustment will be in terms of output, employment and prices. Needless to say the Canadian economic situation will be greatly affected by the outcome in the United States.

In the area of monetary policy, the Federal Reserve System has taken steps to slow down an extremely rapid rate of bank credit expansion. Since the beginning of this year Federal Reserve discount rates have risen in five steps from 4 1/2 per cent to 6 1/2 per cent. Other short-term interest rates in the United States have also risen sharply. The prime lending rates of the commercial banks are now generally at a nominal level

of 7 1/2 per cent, which implies an effective level of about 8 1/2 per cent after taking account of the widespread practice of requiring compensatory balances.

Against this economic background we have been concerned about certain features of recent financial developments in Canada. So far this year bank loans have risen at an annual rate of almost 30 per cent, a distinct acceleration compared to the already rapid increase of 22 per cent in 1972. A 30 per cent rate of increase in bank loans is considerably higher than is needed to help finance continuing sustainable growth of the economy. If allowed to continue unchecked such rapid loan growth, and the associated rapid growth of money holdings in Canada, would pose a serious risk of adding to inflationary pressures and of reducing the chances of future stability of the economy. Some moderation is clearly needed.

The Bank of Canada has conducted its operations in such a way that the extraordinarily rapid expansion of bank loans this year has had to be financed in part by a reduction in bank liquidity in order to prevent it from being fully reflected in the rate of monetary expansion. In the circumstances the unusual strength of credit demands in Canada together with the relatively high and rising level of short-term interest rates in the United States have tended to push interest rates in Canada upward, particularly short-term rates including bank deposit and lending rates. Although the Bank of Canada has acted to temper the pressures in financial

markets, it has been necessary to permit an upward movement of interest rates in order to exercise reasonable control over the monetary situation. The Bank of Canada raised its own lending rate by 1/2 per cent on April 9 and May 14 and by a further 1/2 per cent effective today.

In connection with these steps to bring about some moderation in the overall growth of chartered bank lending, the banks have given assurances that they will, in accordance with their normal policies, continue to pay particular attention to the needs of small businesses which do not have easy access to other credit sources and to applications for credit in the slower growth regions of the country. The banks have also been asked to resist unusual requests for funds from foreign corporations or foreign subsidiaries in Canada in order to give priority to requests by their Canadian customers for funds to be used for Canadian purposes.

A moderation of the growth of the banking system can be achieved while still leaving ample scope for rates of credit and monetary growth fully adequate to sustain the economic expansion. There is, I find, a common tendency to try to describe monetary policy with a vocabulary of only two words -- "tight" and "easy". This is not very illuminating. What we want to bring about is a moderation of the recent extraordinary rates of bank credit expansion. We want to do this in order to lessen the risk that excessive demand pressures will develop in the months ahead.

The underlying objective is to increase the prospect of maintaining the high levels of employment and output that now seem to be within our grasp.

NOT FOR PUBLICATION BEFORE 2:00 P. M. EASTERN STANDARD TIME, NOVEMBER 5, 1973

REMARKS BY R.W. LAWSON
SENIOR DEPUTY GOVERNOR, BANK OF CANADA
TO JOINT MEETING OF
THE REGINA CHAMBER OF COMMERCE AND THE REGINA ROTARY CLUB
REGINA, NOVEMBER 5, 1973

Remarks by R.W. Lawson
Senior Deputy Governor, Bank of Canada
to Joint Meeting of
the Regina Chamber of Commerce and the Regina Rotary Club
Regina, November 5, 1973

(Introductory remarks.)

I want now to make some comments on monetary policy in Canada and on the way that it has responded to recent economic developments in Canada and abroad.

Perhaps I should make it clear that when I talk about monetary policy I am talking about the use which the Bank of Canada makes of the powers that it has to regulate the rate of growth of the banking system in Canada. Changes in the rate of growth of the banking system affect directly the availability of bank credit, the growth of the money supply, and the level of interest rates, especially short-term rates. These in turn affect the flow of expenditure on goods and services in Canada, the foreign exchange rate, and the flow of expenditure on exports and imports. It is these linkages that enable monetary policy to have an influence on the performance of the economy. Because there is a considerable time lag between the implementation of monetary policy and most of its effects, such policy must necessarily be forward looking. While the influence of monetary policy can over time be considerable, it is of course only one of a number of factors which affect the performance of the economy.

There is no doubt that monetary policy in Canada was strongly expansionary in the three years or so to the spring of this year. Let me

give you a few figures. During that period general loans made by the chartered banks rose at an average rate of 22 per cent per year. The major Canadian dollar assets of the chartered banks rose at an average rate of 19 per cent per year. Using the broadest definition of money -- that is, total holdings of currency and bank deposits -- the money supply increased at an average rate of 18 per cent per year. If the money supply is defined to include only currency and demand deposits, the figure is 14 per cent. For a three-year period these rates of growth are very high by any standard.

Due in part to these high rates of monetary expansion, interest rates in Canada declined substantially over the period. If the comparison is limited to nominal rates only, interest rates in the early months of this year may not have seemed particularly low by historical standards, but if account is taken of the underlying rate of decline in the value of money, interest rates this spring were unusually low.

The reason for such an expansionary monetary policy during this period lay in the fact that the level of economic activity in Canada was below what was desirable. Monetary policy was thus directed towards encouraging an increase in the demand for goods and services in Canada by making credit readily available on attractive terms.

A related consideration had to do with the foreign exchange rate. Strong upward pressure on the foreign exchange value of the

Canadian dollar in May of 1970 led the Government to free the Canadian dollar to float in the exchange market. The Canadian dollar then appreciated considerably. In view of the underemployed state of the Canadian economy, it was desirable that the degree of appreciation should not be such as to choke off exports or overdo imports. One element that is nearly always of importance in our exchange market is the flow into or out of Canada of funds seeking the highest interest return consistent with the risks involved. Insofar as possible the Bank of Canada wanted to avoid seeing interest-induced capital inflows put undesirably strong upward pressure on the Canadian exchange rate. Given what was happening to interest rates in the United States and elsewhere abroad during this period, an expansionary monetary policy in Canada was indicated.

It is clear in retrospect that the Canadian economy was expanding strongly during 1971 and 1972. The growth during 1971 was evident at the time, but for a while it was not easy to see that the underlying economic situation continued to be strong through 1972 and into 1973. The reason for this is that during the autumn months of 1972 -- just a year ago -- a number of current economic indicators turned weak and made it look as if the economic expansion was faltering badly. Unemployment as measured by the Labour Force Survey was put initially at 7.1 per cent, seasonally adjusted, for September 1972. The index of industrial production was flat through the third calendar quarter of the year, and the first GNP estimates

for that quarter showed an actual decline in real output from the previous quarter. On the basis of these figures many gloomy statements were made about the growth prospects for the economy.

However, the expansion did not falter. On the contrary, economic growth as measured by the available statistics leapt forward dramatically through the next six months, exceeding the rate of growth for any other six-month period since the mid-1960's.

This bit of economic experience illustrates very well what is perhaps the most difficult single problem in stabilization policy, namely that of assessing correctly the current underlying thrust of the economy. As a practical matter it is not enough simply to suspect what it is -- it is necessary both to have sufficient confidence in the assessment to act on it, and to be able to convince those affected to tolerate the action. In the present state of the art of economic analysis this is never easy, and it is sometimes almost impossibly difficult. One element in the problem is that almost all the current economic indicators are inevitably subject to a considerable margin of error. They are in fact often revised substantially at a later date when more information becomes available, and are often revised more than once. Another element is that particular economic indicators are much less significant in some economic environments than in others. The secret of good economic analysis lies in fact fully as much in knowing what current economic indicators to doubt as in knowing which

ones to give weight to. The level of economic activity does sometimes deviate sharply from its underlying trend, and the problem is to recognize deviations as such and not misinterpret them as indicating changes in the underlying trend. These are the reasons why we in the Bank of Canada devote a good deal of effort to analysing the economic scene, and why we regard such work as the heart of our business. What we are searching for is the direction and strength of the underlying thrust of the economy. That thrust doesn't bounce around from month to month, and is at times at variance with some of the latest statistics.

Whatever the path by which it got there, the Canadian economy has clearly been operating at a very high level relative to its capacity for the past six months. We have been living for several months in an environment that is characterized far more by shortages than by surpluses. As you are well aware, many of the shortages are world-wide. What has in fact happened this year is that nearly all the major countries in the world have reached very high levels of economic activity at the same time -- a coincidence of timing that is unusual. This widespread prosperity has generated an enormous demand for primary commodities, including foods, and the pressure on world supplies has been exacerbated by some poor harvests and by some other short-falls on the supply side. It has been further exacerbated by the recent outbreak of fighting in the Middle East. In these circumstances such facilities as we have in Canada

to contribute to the world supply of primary commodities are being taxed to the limit. Other facilities in Canada producing for the home or the export market are for the most part similarly strained; stocks are low, order books are long and deliveries are slow. One of the happier aspects of the present situation is that markets are strong for the main products of regions of Canada that have hitherto not shared equally in the prosperity being enjoyed in other regions.

The labour market in Canada is also tight. There are nearly always shortages of some skills in Canada, but in recent months the shortages have been widespread, and have included less-skilled as well as skilled workers. Yet a few weeks ago the Labour Force Survey reported a rate of unemployment (seasonally adjusted) in September of 6 per cent, a rate which has hitherto been regarded in this country as indicating a good deal of slack in the economy. How the recorded unemployment rate can be so high when the labour market generally is so tight is a puzzling question. Whatever the answer to that question, it seems clear to me that the circumstances of some of those who are today being recorded by the Labour Force Survey as unemployed are quite different from the circumstances that are usually thought of as being involved in unemployment. The overall unemployment rate has become difficult to interpret, and it is at present a much less useful guide than it used to be to the amount of slack in the economy.

In light of the changing economic situation and prospects the Bank of Canada decided in the spring of this year that it should no longer willingly accommodate the high rates of growth of bank credit and of the money supply that were continuing, and it began to try to reduce these rates to more sustainable levels. At the same time it wanted to avoid a sharp and disruptive change in the lending practices of the chartered banks. In the hope that it would help to achieve a smooth transition to moderate rates of monetary expansion, we tried to make as clear as we could to both the banks and the public what we were seeking. We encouraged the banks in their policies of trying to ensure that the needs of small business and of borrowers in less prosperous parts of the country are reasonably accommodated. We also encouraged them to maintain reasonable continuity in their residential mortgage lending.

In the economic environment that existed this shift in monetary policy was virtually certain to involve an increase in short-term interest rates. If the demand for credit remained strong, any moderation in the volume of bank lending was bound to increase the competition for, and the price of, borrowed money. In the face of a strong demand for credit, there is in fact no way of reducing the rate of monetary expansion without generating upward pressure on interest rates. That is why increases in the Bank of Canada's own lending rate, the Bank Rate, were necessary. That rate was raised from 4 3/4 per cent to 5 1/4

per cent in April of this year, and was subsequently raised by an additional 1/2 per cent on four other occasions, the most recent being September 13. Other short-term interest rates, including the lending and borrowing rates of the chartered banks, have risen by about 3 percentage points in the last six months. The interest rate on residential mortgages, which in Canada is tied fairly closely to the market rate on five-year money, has also risen, but only about one-half as much as short-term rates. Long-term interest rates are also higher, but by less than five-year rates.

Until a few weeks ago the upward pressure on interest rates in Canada was strongly reinforced by high and rising rates in the United States and in markets overseas. During most of this year short-term interest rates in the United States have been well above those in Canada; during the summer months the difference was as much as three percentage points. Through August and early September, for example, the rate of interest being paid by banks in Canada on large short-term deposits was 7 1/2 per cent, while U.S. banks were paying 10 1/2 per cent or more. The difference in the effective cost of bank credit to prime borrowers was about as great. Short-term interest rates in the Euro-dollar market and in Britain and Germany were even higher.

The reason for the rapid increase to such high levels of short-term interest rates abroad was that the monetary authorities in several countries, notably in the United States and Germany, were

following policies of vigorous monetary restraint in the face of very heavy demands for credit. They were not willing to prevent the increase in short-term interest rates by permitting what they would have regarded as excessive rates of monetary expansion.

As you know, Canadian financial markets are closely interconnected with external markets and are thus sensitive to interest rate developments abroad, especially to those in the United States. When interest rates in Canada differ substantially from those in foreign markets, it is normal to see large movements of funds across our borders. A substantial part of the funds that moved out of Canada this summer in response to interest rate differentials did so on a covered basis, that is, with the exchange rate risk covered by a matching forward exchange contract, and such flows were self-limiting in that they gave rise to an increase in the price of forward cover that offset the higher interest yield available abroad. The volume of outflows on an uncovered basis seems to have been less than one might ordinarily have expected, and I attribute this to the uncertainties that there were in world foreign exchange markets during the summer months. Under more normal circumstances the interest rate differentials that existed this summer would probably have put more downward pressure on the Canadian exchange rate than they did.

In the last few weeks short-term interest rates in the United States have declined appreciably, reflecting a widespread

expectation that existed in financial markets of some easing in the degree of monetary restraint in that country. At the same time there was some upward movement in short-term market rates in this country. As a result, short-term rates in the United States and Canada are now much closer together than they have been for some time.

There are now many indications that the growth of output in Canada during the third quarter of this year was very small, well below the long-term average. The level of economic activity appears in fact to be following a path similar to that of a year ago. It seems evident this year that the economy's growth is being restrained by limitations on the supply side and not by a short-fall of demand; in the third quarter these limitations included major work stoppages in the transportation and forest product industries. By and large demand seems to be sufficiently strong to absorb all the output that the economy is able to produce, and while demand may be weakening in some sectors, it is strengthening in others. There is therefore much less tendency than there was a year ago for observers to interpret the current economic statistics as evidence of underlying weakness in the economy.

Meanwhile world-wide shortages continue to generate strong upward pressure on prices in Canada. While the strains in the world market for oil may persist, it is presumably only a matter of time

-- and in some cases perhaps not a long time -- before the world balance between supply and demand for many other basic commodities will become less abnormal. It does not therefore seem unrealistic to foresee some overall easing in the upward pressure on Canadian prices from external sources. One obvious danger in the meantime is that the current surge of price inflation get built into the cost structure in Canada. To the extent that we in Canada allow our cost structure to be ratcheted up, we shall find that any future easing in world prices will be offset in respect of its impact on the trend of prices in Canada by price increases generated at home. To the extent that this happens we shall have missed a favourable opportunity to put our house in better order, and we shall have no one but ourselves to blame.

There is no doubt that in virtually all of the more developed countries of the western world the most urgent current economic problem is seen to be the containment of inflation. It is from inflation that the major threat to sustained high levels of trade, employment and output is seen to come. I doubt that many people would regard Canada as an exception. The problem for the national authorities in all these countries is to find the blend of policies that is most likely to be effective in containing inflation without generating unacceptable side-effects in the process. For our part we in the Bank of Canada believe that the most constructive contribution that we can make is to strive for moderate rates of monetary expansion while avoiding a rigid approach which could have disruptive effects on the economy.

NOT FOR PUBLICATION BEFORE 7:30 P.M. PACIFIC STANDARD TIME
JANUARY 21, 1974

Canada

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE ANNUAL DINNER MEETING OF THE
VANCOUVER BOARD OF TRADE
JANUARY 21, 1974

Remarks by Gerald K. Bouey,
Governor, Bank of Canada,
Vancouver Board of Trade, January 21, 1974

Last July when I accepted the kind invitation of your President to speak at this annual dinner meeting of the Vancouver Board of Trade, I had hoped that by now we might be moving into a much less inflationary world environment, with good prospects here in Canada for maintaining a satisfactory rate of economic growth and for achieving an improved cost and price performance.

Our prospects for growth remain good, but there is now less reason for optimism about the trend of prices.

There were two main reasons for expecting a marked easing of external price pressures on the Canadian economy. The first was that with the passage of time the temporary scarcity of many foodstuffs and industrial materials could be expected to ease, partly because of better harvests and partly through the response of world supplies to last year's sharp upward movement in commodity prices. The other was the expectation that as we moved into 1974 the pressure of demand would moderate in a number of the main industrial countries, leading to more normal and sustainable rates of economic growth.

Since last autumn, however, a new and major source of disruption has been injected into the world economic picture -- the problem of oil -- and the resulting uncertainties have left the immediate outlook for the world economy rather up in the air. It is difficult enough at any time to try to assess how the economic

situation is likely to develop in the period ahead. In many countries today the economic shock of sharply higher prices for oil and oil products -- and also, in some cases, of concern about access to supplies of imported oil even at current world prices -- has presented problems of adjustment without parallel in modern peacetime history.

Although the impact on Canada's supply of petroleum products may not turn out to be severe, we are of course exposed to the direct and indirect effects of dramatic increases in world petroleum prices. These add a new dimension to the cost and price problems that we already have, and confront us with potentially large shifts in the regional and sectoral pattern of income and expenditure flows within the Canadian economy. The world petroleum situation also seems likely to affect Canada in other ways, mainly as a result of its more severe impact on the balance of payments positions, and perhaps also on the levels of economic activity, of some of our trading partners. Nevertheless Canada appears to be in a better position than most countries so far as its prospects for continuing growth during 1974 are concerned.

I would like to return to this matter before I conclude my remarks, but first I would like to say something about the way in which monetary policy has evolved over the past year in response to the developing economic situation and outlook.

Since the early months of 1973 the Bank of Canada has been following a policy much less conducive to high rates of growth of money and credit in Canada than it followed in 1971 and 1972.

I have described the reasons for this change of approach in earlier speeches and public statements. The fundamental reason was that the level of activity of the Canadian economy in relation to its productive capacity had risen to the point where a strongly expansionary monetary policy was no longer appropriate. By the spring of 1973 it was becoming increasingly clear that for the immediate future the level of over-all demand in Canada was more likely to be too high than too low.

The subsequent course of monetary and financial developments in Canada has reflected both the continued strength of the economic situation and this change in the posture of monetary policy.

Although the statistical record for 1973 is not yet complete, the salient features of our economic experience last year are already reasonably clear. Gross National Expenditure in money terms in 1973 was 14 to 15 per cent higher than in 1972. Among the categories of spending that contributed to this very large increase in demand on our productive capacity were consumer spending, outlays on residential construction and export sales. Business expenditures on new plant and equipment also showed a marked acceleration last year and seem likely to provide strong support for continued economic expansion in 1974.

The strength of world demand in 1973 gave rise to substantial increases both in the prices and in the volume of export shipments of many of the commodities we supply to the rest of the world, thereby adding greatly to levels of income and employment in the various

regions of Canada. Striking examples of this are readily apparent here in British Columbia in the case of many of your basic industries such as forest products, mining and fishing. Similar examples come to mind from the recent economic experience of other regions of Canada, including regions that specialize in other export products. Thus, while the year 1973 was one of sharp changes in exchange rate relationships among major currencies and of great uncertainty about how the world payments system might evolve, it was nevertheless another year of rapid expansion of world trade in which Canada and most other countries have shared.

The rapid growth of spending in Canada in 1973 was reflected in an unusually large increase in the level of economic activity, although the course of the expansion was rather uneven during the year. A remarkably rapid surge of growth last winter was followed by six months or so of relatively slow growth, owing in part to limitations on productive capacity and to the effects of strikes, but there seems to have been a strong rebound of activity in the closing months of the year. If one takes the year as a whole, the total physical volume of output of the economy was close to 7 per cent higher in 1973 than in 1972. This was a higher rate of growth than in any year since the mid-1960s, and well above the annual average of 5 to 5 1/2 per cent that we can expect to achieve over the longer run.

This growth in output was accompanied by the largest increase in employment attained in Canada since the 1940s, whether measured in terms of the number of new jobs or in terms of the rate of increase. The 5.2 per cent increase in employment in 1973 compares with a previous post-war record growth in employment of 4.2 per cent in 1966. It is particularly gratifying that all regions of the country shared in the record gains in employment. Thus in the Atlantic provinces as in British Columbia the number of employed people was 6 1/2 per cent higher than in 1972, and in Quebec the increase was close to 6 per cent.

With these extraordinarily rapid increases in output and employment in 1973 the economy gave increasingly clear indications of strain as the year progressed. The surge of growth last winter pushed the economy up against the effective limits of its productive capacity in many areas, and we began bumping against these capacity limits at much higher levels of recorded unemployment than one might have expected on the basis of previous experience. The unemployment rate last year as measured by the Labour Force Survey averaged 5.6 per cent, a level that in earlier years would have been associated with rather easy conditions in labour markets but during most of 1973 was associated with labour market tightness. Mounting pressures on the economy's capacity to produce also showed up in growing scarcities of a wide variety of goods, in lengthening delivery delays and in rapidly rising order backlogs. Thus economic expansion could no longer be sustained at rates in excess

of the growth in the economy's productive capacity. Further efforts to force the pace would not have added significantly to real economic growth but would merely have stepped up an already high rate of inflation.

I need not labour the point that in 1973 Canada experienced very rapid rates of price increase. The acceleration of price increases in Canada was largely the reflection of the world-wide outbreak of inflation to which I have already referred. This was caused by the interaction of scarcities of important foodstuffs and basic commodities with very strong demand growth throughout the world. We cannot expect this wave of inflation to subside quickly. While some temporary scarcities may be overcome as the pace of demand growth moderates in the industrial world, high prices for materials and rising labour costs will continue to work their way through the price structure in 1974, and to these must now be added much higher petroleum prices.

The rapid expansion of economic activity in 1973 together with the sharp increase in prices gave rise to heavy demands for credit. At the same time the Bank of Canada was seeking to bring about a transition to less rapid rates of monetary and credit expansion in order to help moderate spending pressures in the economy. In these circumstances the efforts of the chartered banks to meet the strong demand for loans soon led to intensified pressure on their liquidity and on short-term interest rates. The upward pressure on interest rates was strongly reinforced by an even sharper rise in short-term interest rates in the United States and Europe.

Beginning last spring I tried to make it clear, both publicly and in discussions with the banks, that the circumstances called for a slowing of the growth of bank loans rather than a drastic curtailment. The banks were also encouraged in their expressed desire to try to achieve this objective in ways that would minimize the impact on small business borrowers, borrowers in the less buoyant regions of Canada, and residential mortgage borrowers. This implied, of course, that efforts to restrain the rapid expansion of bank credit would have to be concentrated mainly on large business borrowers. This in turn was bound to add to the upward pressure on interest rates, since most large borrowers are strong enough to make their credit demands felt in other areas of the market as well as in the banking system.

By some measures it looks as though the firmer posture of monetary policy since last spring has so far achieved little, if any, moderation of credit and monetary expansion in the face of the very strong and persistent demand for credit. In December, for instance, the general loans on the books of the chartered banks were still a full 26 per cent higher than a year earlier, and the public's total holdings of currency and chartered bank deposits were 18 per cent higher. Both of these increases were, in fact, somewhat larger than in 1972.

It should be noted, however, that the behaviour of these particular series can be substantially affected in the short run by temporary shifts in the channels through which credit flows occur. Thus the placement of short-term paper in the money market is for

many large borrowers a ready alternative to obtaining a loan from a bank. Whether short-term borrowing of this kind is channelled through the paper market or through the banking system depends in part on fairly small changes in the relative interest cost. Since last summer there has been a sizeable drop in the outstanding amount of short-term paper issued by non-financial borrowers as paper rates rose up to and beyond bank prime loan rates, and some part of the large increase in bank loans during this period is unquestionably related to this development.

It seems likely that the large increase in the outstanding amount of the banks' fixed-term deposits has also been inflated to some extent by the corresponding shift of short-term investment funds from the paper market to the banks. Another factor working in the same direction has been the greatly increased flow into fixed-term personal deposits at banks and trust companies of funds that a year earlier were flowing into the Government's bank balances as a result of heavy purchases of Canada Savings Bonds.

When one takes account of such shifts in the pattern of credit flows one does see some evidence of a moderation of the growth of short-term credit. There has, moreover, been a distinct slowing in the growth of the privately-held money supply on the narrower definition which includes currency and demand deposits but not time deposits. On this definition, average money holdings in the final quarter of 1973 were 12 per cent higher than their level a year earlier, but the annual rate of growth had slowed to 8 per cent over the most recent half-year.

The interaction between strong credit demands and the changed posture of monetary policy in an international environment of sharply rising interest rates led to substantial increases in Canadian interest rates during 1973. Although the Bank of Canada did not press its policy to the point where Canadian short-term rates rose as high as the peak levels reached in the United States and in major financial markets abroad, the increases were nevertheless quite large. Thus typical rates on short-term paper were some 5 percentage points higher at year-end than at the beginning of 1973. Chartered bank prime lending rates for larger borrowers had moved up by 3 1/2 percentage points and there had been comparable increases in key deposit rates. The Bank of Canada's own Bank Rate had been raised in five steps to the present level of 7 1/4 per cent that was established in September.

Late in 1973 short-term interest rate levels in Canada came under renewed upward pressure and further increases in some of these rates occurred. Since there was a reasonable possibility that this pressure would prove to be no more than a temporary phenomenon, the Bank of Canada operated to cushion the upward pressure on rates even though this was accompanied by a temporary bulge in bank loans and deposits.

It should be emphasized that interest rate movements play an indispensable role in helping to keep the growth of the economy orderly and prices and costs under control. Given the pressures on productive capacity that emerged last year and the associated

strength of credit demands, it was essential that interest rates should rise. To have attempted to prevent rates from rising as much as they did by permitting even faster monetary growth would have added to the demand pressures on an economy that was already operating at virtually full stretch, and would thus have added to subsequent rates of price increase. In time, moreover, the exercise would have proved self-defeating as these higher rates of inflation led savers to insist on correspondingly higher interest yields in compensation for the accelerating decline in the value of money.

This brings the story up to the onset of the petroleum crisis. The slack in the Canadian economy had been absorbed by a period of vigorous expansion, so that the growth in output in 1974 could not be as large as it had been in 1973. External price pressures seemed likely to ease and some sources of demand were expected to moderate, but a further strong rise in investment spending would help to sustain economic expansion at a pace that would still involve some risk of excessive demand pressure on capacity. Following large increases in prices, profits and farm incomes, there were already signs in the closing months of 1973 that wage and salary increases were beginning to escalate. In these circumstances the kind of demand management policies called for seemed reasonably clear -- to try to maintain a climate of demand favourable to continued economic growth at a substantial rate, but not so strong as to jeopardize the prospects for improvement in our price situation.

The sudden emergence of the oil problem has affected the world economic outlook in a variety of ways.

There are the direct consequences of such physical shortages as may occur. How severe these will turn out to be remains obscure, but they may lead to some reduction in the growth of output and employment in some countries. The effects of any general shortages may be intensified by shortages of particular items such as petro-chemical feed-stocks and bunker oil for ships, which may add temporarily to production difficulties in particular industries and restrict the movement of goods.

The sharp jump in oil prices will add substantially to world-wide cost increases. A broad range of goods and services whose production entails the use of petroleum will become more expensive, in some cases substantially so. The world had been looking forward to some easing in 1974 of the extraordinary increases in prices and costs that had occurred in 1973 even before the recent rise in petroleum prices. Now, unfortunately, such prospects have been pushed further into the future.

Another consequence of the sharp rise in petroleum prices will be to generate massive transfers of income from consumers of oil to producers of oil and to governments. This will leave oil consumers with less money to spend on other things. To the extent that such transfers are not offset, they will tend to reduce world levels of demand.

For most countries the transfer of income from consumers of oil to producers and governments is a transfer from inside

the country to outside. Since Canada's exports and imports of oil are roughly equal, our situation is different. Here, the transfers of income constitute an internal problem. As you know this is a matter that is currently receiving the attention of our governments.

For the world as a whole the balance of payments implications of these transfers at the present level of prices are truly staggering -- adding up to an increase of many tens of billions of dollars in the combined petroleum bill of the oil-importing countries. Such an unprecedented shock to the international trade and payments system is bound to force substantial readjustments on the countries most affected, and this in turn will affect other countries.

In the short run at least, the oil-exporting countries will not be able to spend more than a fraction of the massive increase in their incomes on increased imports from the rest of the world. This means that for the time being the oil-importing countries as a group will have little scope for correcting the weakening of their external trade accounts as they would in more normal circumstances -- by reducing domestic demand and using the resources freed from consumption at home to expand their export earnings. Instead, their oil imports will have to result in large deficits on trade account and will have to be covered for the immediate future mainly by external borrowing and by drawing on their foreign exchange reserves. The counterpart will be a massive build-up of financial claims by the oil exporting countries.

This is a very unattractive prospect for the richer countries, who have generally wanted to pay for their imports with exports and have not liked what was involved in borrowing from other countries. It is even bleaker for the poorer countries, whose foreign exchange reserves are modest and whose capacity to carry external debt is already over-strained.

It will be of the greatest importance that the major trading countries see this problem in its international context, and refrain from unwarranted attempts to push on to other countries the increases in their trade deficits arising from the oil situation. Such attempts would compound the threat to economic stability and growth everywhere. It is most desirable in these circumstances that countries consult very closely together to arrive at consistency in their balance of payments aims and policies. I was encouraged to see that both the nature of the over-all problem and the need for close international consultation and co-operation in this area were clearly recognized in the discussions of the Ministers of Finance of the Committee of Twenty that I attended in Rome last week. The problems of adjustment are enormous, and as yet it is far from clear how they will be accommodated.

The effects on the Canadian economy of these external developments, as well as the internal aspects of the oil problem, will require close attention in determining the setting of monetary policy. Our basic objective, however, will remain unchanged: to achieve and maintain a monetary climate that will help the economy

realize the growth of output and employment permitted by supply conditions, and that will at the same time not jeopardize our longer-term chances for a better cost and price performance.

Not for publication before 2:30 p.m. Eastern Daylight Saving Time
September 16th, 1974.

CANADIAN CONFERENCE ON BANKING

WOULD CANADIAN MONETARY POLICY BE MORE EFFECTIVE IF OTHER DEPOSIT-TAKING FINANCIAL INSTITUTIONS WERE SUBJECT TO THE DIRECT EFFECTS OF BANK OF CANADA OPERATIONS IN THE SAME WAY AS THE CHARTERED BANKS?

PRESENTED BY

MR. GERALD K. BOUEY

GOVERNOR

BANK OF CANADA

SEPTEMBER 16 and 17, 1974

Would Canadian monetary policy be more effective if other deposit-taking financial institutions were subject to the direct effects of Bank of Canada operations in the same way as the chartered banks?

Governor Mitchell and I have been asked to respond to an important question about the powers that a central bank needs in order to do its job effectively. Do the operations of the central bank impinge directly on a large enough proportion of the country's deposit-taking institutions for effective monetary control? Discussion of this question is timely. In the United States it is under active consideration, and I have no doubt that in Canada "bank, near-bank" questions will have to be considered as we prepare for the next decennial review of banking legislation.

The powers and the technical arrangements that a central bank needs to do its job depend on how the job is viewed. The immediate targets of central bank action and the manner in which they are pursued vary to some extent from one country to another, and even within particular countries they have evolved over time in the light of accumulating experience and changing circumstances.

Some central banks rely almost entirely on the indirect influence of cash reserve management to regulate the pace of monetary and credit expansion in terms of broad aggregates, leaving it mainly to the workings of private financial institutions and markets to sort out the specific impacts on the cost and availability of credit to particular classes of borrower and lender. The outcome may well be modified by government action such as direct lending programs or other forms of intervention, but these activities are not viewed as part of the central banking job as such. The application of specified minimum cash reserve requirements to banking institutions is the main technical arrangement usually associated with this general approach to monetary policy. Since this is the basic approach followed in Canada, the central question for today's discussion is whether the Bank of Canada could achieve its main policy objectives more effectively if deposit-taking institutions other than chartered banks were subject to the same kind of cash reserve requirements as banks.

The role of monetary policy may, however, be taken to go beyond a general influence of this kind and to encompass as well measures directly influencing the allocation of credit to particular classes of borrowers or the relationship among particular rates of interest. Many central banks employ supplementary techniques designed for these purposes and some rely heavily on them. In some cases governments themselves, rather than central banks, intervene in this way. If cash reserve management is to be supplemented by formal or informal measures that intervene more

directly in market processes, the question is whether they should be imposed on the banks alone or should extend beyond them.

The laws and regulations that apply to deposit-taking institutions in Canada have evolved over many years. They do not reflect a single grand design, but are rather something of a patchwork made up of pragmatic responses to particular problems that from time to time seemed to call for solution. These responses have come from provincial governments as well as from the Government of Canada, and this has contributed to a situation in which differing rules are in many cases applied to essentially the same kind of business. The result has not been an entirely haphazard set of laws, but it is certainly not the result one would have arrived at if it had been possible to sit down with a blank piece of paper to draft a coherent framework of legislation.

If one were able to start from scratch in establishing the legal framework for the conduct of monetary policy, one would presumably begin by deciding what technical powers the central bank needs to exert its general influence over the financial environment and, secondly, what additional powers, if any, it should have to intervene directly in market processes. With this job description in mind one would then, presumably, so write the law that any obligations to be imposed on financial institutions for the sake of an effective monetary policy would apply equally to all institutions doing the relevant kinds of financial business.

Thus cash reserve requirements applied to institutional deposits, which are the fulcrum of monetary policy as we conduct it in Canada, would

be imposed equally on deposits having the same characteristics, at whatever financial institution they might be held. This obvious approach would seem to be logical, equitable and efficient. Why would one do otherwise? Similarly, any authority given the central bank to bring about a particular allocation of credit or a particular structure of interest rates would apply equally to all relevant areas of the financial system. Equal treatment in equal circumstances is an important principle of law, and in economic affairs it contributes to an efficient allocation of resources. Departures from this approach may be desirable in the interests of particular social or economic objectives, but the starting point for regulation and control of the financial system would surely be a uniform, comprehensive framework of laws and regulations.

As we all know the situation in Canada is some distance from that ideal of logic, equity and efficiency. Similar kinds of business done by financial institutions are subject to different limitations and requirements depending on the particular statute under which the institution is organized. The requirements that are of particular interest to the central bank -- minimum cash reserves held solely in the form of claims on the Bank of Canada, and a variable minimum level of secondary reserves -- apply only to the chartered banks. Even here they do not apply in a fully uniform way to all deposits. While the Bank Act does require banks to "maintain adequate and appropriate assets against liabilities payable in foreign currencies", there are no specific minimum reserve requirements

on foreign currency deposits, even those covered by a Canadian dollar forward exchange contract and which are, therefore, the same in all essentials as Canadian dollar term deposits. But the main feature of the system is that minimum cash reserve requirements are imposed on banks and not on other institutions.

And who are the Banks? They are defined in law not by the nature of the business that they do but by the fact that they are incorporated under a particular Act. Although The British North America Act assigns jurisdiction over banking and the incorporation of banks to the federal Parliament, our laws do not provide a clear-cut definition of banking. Provincial governments as well as the federal Government have for many years incorporated and regulated institutions that do many of the same kinds of business as banks, but which are subject to substantially different limitations.

For example, although trust and loan companies, caisses populaires, credit unions and the depository institutions owned by certain provinces can offer deposit accounts that are in all essentials the same as those at banks, they are not subject to the same reserve requirements. The banks have to hold cash reserves at the central bank, earning no interest, equal to 12 per cent of Canadian dollar demand deposits and 4 per cent of Canadian dollar time deposits. The various pieces of legislation that regulate the other deposit-taking institutions in most cases require them to keep specified

minimum liquid reserves, but these may usually include securities of various kinds and term deposits which bear interest as well as demand deposits. The cash reserves of these institutions are not held at the Bank of Canada; by the same token these institutions do not have the same access to central bank credit as do the chartered banks.

There are, of course, many other provisions of law that affect depository institutions, some of them obviously concerned with the same problems of liquidity that must be of concern to the central bank in its role as lender of last resort. Arrangements for inspection and requirements for publication of condition statements differ among categories of institution, and other rules affecting the conduct of their business also differ substantially. There is no need to spell out the whole catalogue of minimum and maximum asset ratios, permitted investments and prohibited investments, basket clauses, laws that in some cases specify minimum capital requirements and in other cases are silent on the subject, differing tax treatment and so forth. I do not wish to suggest that these various federal and provincial laws taken by themselves are inadequate, but it is fair to say that consistency and uniformity are not their obvious hallmarks.

A particularly anomalous aspect of the matter has recently been brought to prominence by the rush of foreign banks to extend their business into Canada. The Bank Act contains general limitations on the ownership of Canadian banks that prevent foreign banks from operating offices in their own

name in Canada, or from owning any substantial part of a Canadian bank. Moreover federal law as well as some provincial legislation covering trust and loan companies contain similar restrictions. However other federal and provincial laws provide avenues of incorporation whereby foreign banks are able to extend their business into Canada, and they have done so in various ways including the establishment of wholly-owned subsidiaries using general purpose names with a financial ring.

Many of those who are engaged in setting up such affiliate institutions in Canada come to see us, and I may say that whatever the form of incorporation or corporate name they may have chosen, we have been in no doubt that we were talking to bankers. Although these Canadian affiliates cannot use the name of the parent bank, they can usually do most of the kinds of business that are permitted to Canadian banks. Their short-term liabilities are in all essentials the same as bank deposits: they are indeed normally backed by the guarantee of the parent banking institution although not in practice subject to any regulation by Canadian authorities. Moreover these companies are able to do some kinds of business, notably leasing, that Canadian banks may not enter directly.

I might digress for a moment to report that the Bank of Canada is now collecting regular returns from these new Canadian financial institutions that are owned entirely or in substantial part by foreign banks, and will soon begin to publish a combined monthly balance sheet for the

group. The reporting companies had total assets of almost $1 billion at the end of June compared to just over $600 million at the end of 1973. In June the assets included $121 million of leasing business, $100 million of real estate loans, and $584 million of other loans to businesses: of this latter amount, $388 million was in loans with a term of less than a year. More than one-half of the total assets were financed by the issue of short-term paper, and the remaining sources of funds included $116 million of loans from Canadian banks. Although the figures are still relatively small -- less than two per cent of the Canadian dollar assets of the chartered banks -- these new arrivals on the Canadian financial scene have grown rapidly during the start-up period of their operations.

To return to the legislative framework for banks and near-banks, an admission that the present arrangements are anomalous in certain respects does not mean that they fail to work reasonably well in practice so far as monetary policy is concerned. The technical powers given to the Bank of Canada have in fact proven broadly adequate for the Bank's purposes. Largely through its control over the supply of cash reserves to the chartered banking system, the Bank of Canada has unquestionably been able to exert sufficient influence over the process of monetary expansion to have a major impact on the degree of ease or tightness in financial markets. So much is evident from the record. It is clear that the effects of Bank of Canada operations on the growth of money and credit and on the level of interest rates have not been confined to the chartered banks but

have been felt pervasively throughout the financial system.

As I need hardly tell this group, the Bank of Canada can, by varying the supply of chartered bank cash reserves, influence the operations not only of the banks but of near-bank financial institutions as well. Changes in the supply of cash reserves relative to the banking system's demand for them have the immediate consequence of putting downward pressure on short-term money market and institutional interest rates when reserves are run at relatively high levels, and upward pressure on these rates when the central bank is less generous in providing cash reserves.

If the central bank is a reluctant provider of cash to the banking system so that heightened competition for money balances is pushing short-term interest rates upward, the near-banks must meet these rates or else suffer pressure on their own cash positions. These pressures would result from a tendency for funds to slip away as depositors sought the higher returns available elsewhere and as borrowers tried to take advantage of relatively cheap near-bank sources of credit.

The basic character of these responses is not altered by the fact that the near-banks are not required to maintain a stipulated minimum level of cash reserves nor indeed to hold part of their cash in accounts with the central bank, as the chartered banks must do. The function of the banking system's cash reserve requirements is simply to increase the short-run

precision and predictability of their response to changes in the supply of central bank money. So long as the banks are required to hold somewhat larger non-earning cash reserves than they would by choice, they will respond rather sensitively to excesses as well as to deficiencies in their cash reserve positions. And so long as the institutions that are subject to these legal requirements bulk large in the financial system -- and in particular in the business of issuing chequable deposit liabilities -- their response to changes in their reserve positions will have prompt and substantial effects on other financial institutions and markets.

These conditions for the reasonably effective implementation of monetary policy are met in Canada as things stand at present. The chartered banks are dominant enough in the relevant areas of deposit-taking and short-term credit extension to give the Bank of Canada, through its management of their cash reserves, an adequate degree of leverage and precision for monetary control purposes. So far as its needs for statistical information are concerned, it is true that the Bank of Canada's statutory power to collect statistics applies only to the chartered banks. In practice, however, our experience has been that we have obtained excellent co-operation from other institutions, who meet our statistical requests on a voluntary basis.

Although other deposit-taking institutions have been expanding their business rapidly, deposits at chartered banks still comprise about two-thirds of all deposits held by Canadians with financial institutions in Canada.

The chartered banks' share of chequable deposit accounts is even higher. At the end of 1973, 78 per cent of such deposits were held with chartered banks and only 22 per cent -- consisting mainly of chequable household savings accounts -- were held with other depository institutions. While the chartered bank share of deposits has declined in recent years it remains the case that an overwhelmingly high proportion of payments in Canada is made by means of cheques drawn on bank accounts.

Up to the present, then, I am afraid that I cannot blame any shortcomings in monetary policy on deficiencies in the technical arrangements that link the Bank of Canada to the rest of the financial system. The absence of cash reserve requirements applicable to depository institutions other than the chartered banks has never, to my knowledge, frustrated the efforts of the Bank of Canada to bring about as sharp a curtailment of the pace of monetary expansion and as large an associated rise in short-term interest rates as we were prepared to contemplate in the circumstances of the time.

Whether this would continue to be the case in future years if a growing proportion of the country's banking business were taken on by institutions other than the chartered banks is another question. In thinking about the adequacy of our present cash reserve arrangements for purposes of monetary control, one does have to consider the implications of a possible further decline in the chartered banks' share of chequable deposit business. A progressive loosening of the relationship between the amount of cash reserves supplied by the central bank and the probable responses of the institutions which provide the public with most of the money it uses for

transactions purposes would undoubtedly make the effects of central bank operations less predictable.

One must also give some weight to another aspect of the matter. The minimum cash reserves that the chartered banks are required to hold earn no interest and are somewhat higher than the banks would hold by choice. The secondary reserve requirement, which also applies to chartered banks but not to their competitors, can sometimes have a comparable effect of reducing total earnings below what they might otherwise be. Taken by themselves these arrangements work to the competitive disadvantage of the chartered banks, if only to a modest degree. It is true that the banks also have offsetting competitive advantages owing to the very broad borrowing and lending powers available to them, to the peculiar magic of the word "bank" which is reserved to them, and in some cases to sheer size. Nevertheless, it is possible to question the appropriateness of discriminatory arrangements of this kind on grounds not just of efficiency but also of equity, at least with respect to small chartered banks and potential applicants for new bank charters.

It is true that in Canada our concerns on this score do not include one that is relevant in the United States, where fully-fledged banks can be established outside the Federal Reserve System and where member banks can leave the System without forfeiting the advantages of incorporation as banks. Nonetheless it does concern me that in recent years the number of new entrants into the chartered banking system on which

the central bank operates directly has continued to be small by comparison with the number of new institutions that have been set up to do closely similar business under other legislation.

I have discussed the relationship of the Bank of Canada with deposit-taking institutions mainly in terms of the cash reserve requirements because the Bank of Canada Act leaves no doubt that cash reserve management is the major technique of monetary control that the Bank is expected to use. Except for the secondary reserve requirement which applies to the chartered banks, the Bank of Canada has no statutory power to influence the allocation of credit or the interest rates at which private institutions deal. Nevertheless, the Bank has supported agreements that have been entered into at times within the banking system, with the approval of the Minister of Finance, to limit the rates of interest paid on certain types of deposit. The Bank has also on occasion asked the banks to follow particular policies in the conduct of various aspects of their business, such as the composition of their lending. These requests have normally been made in cooperation with the Minister of Finance rather than as completely independent actions by the Bank of Canada.

Since we have resorted to such measures only to a limited extent, their application to the chartered banks alone has not seemed to me to raise serious problems. If much greater reliance were to be placed on the use of such requests, there would be a strong case for extending them beyond the banking system. In certain circumstances

this might be the appropriate course of action. The fact that this general approach has been used to such a limited extent in Canada is in my opinion not so much due to the framework of the financial system as to the many practical problems involved in devising major interventions of this kind in a way that offers the reasonable prospect that they will in fact be effective in the pursuit of their ultimate objective.

I have touched on a number of topics that go beyond the particular matter of the powers needed by a central bank. I would like to conclude by coming back to the question posed in the title of my remarks. It is my view that an extension of the Bank of Canada's powers to cover a broader range of financial institutions has not so far been necessary in order to achieve the central bank's objectives with reasonable efficiency. But this judgment is related to the structure of the Canadian financial system as it has developed to date. Some of the structural trends currently in evidence are not altogether reassuring from this point of view and their continuation could in time make it more difficult for the central bank to do its job effectively.

NOT FOR PUBLICATION BEFORE 1:00 P.M. CENTRAL STANDARD TIME
NOVEMBER 26, 1974

Canada, Bank of Canada

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE
MEN'S CANADIAN CLUB OF WINNIPEG
NOVEMBER 26, 1974

Remarks by
Gerald K. Bouey
Governor, Bank of Canada
to the
Men's Canadian Club of Winnipeg
November 26, 1974

In the years that I lived in Western Canada it used to be said that regardless of the occasion people soon get around to talking about wheat. I am afraid that it is the same with central bankers; they can always be counted on to talk about their own business. I am going to run true to form and do just that, but first I want to say something about the environment in which economic activity is taking place and monetary policy is being formulated. I especially want to refer to certain worldwide influences that may well turn out to be the most important of all the forces operating on our economic situation for some time to come. The fact that I am in Winnipeg encourages me to follow this approach since I have always been aware of a keen interest here in the world scene.

The world economy, as everyone knows, is in a troubled state. It is threatened at one and the same time by the persistence of severe inflation and by the risk of a prolonged interruption in the growth of economic activity.

The combination of ailments that most countries are suffering from is partly new but much of it is old. This is not the first time in the post-war period that we have seen the tide

of inflation reach new peaks well after the economic boom that set off the upsurge has begun to fade. Nor should we regard as altogether unfamiliar, even if much more serious this time, the stresses and strains generated by the recent and largely unforeseen escalation of world inflation. At such times some prices lead the parade while others lag. The prices at which one economic group manages to sell its output are the costs that others are required to pay, so it is not surprising that in many countries today a growing number of firms and industries are caught in a cost-price squeeze, wage disputes are unusually widespread and bitter, and governments are besieged by groups demanding redress for their economic grievances. All of this is part of the price exacted by the wave of inflation that has been let loose in the world.

The origins of this worldwide inflation can, I believe, be understood without great difficulty. One could trace them back quite far, to developments in the 1960s, including the Vietnam war, but I think that for present purposes it is enough to begin by noting that virtually all of the major countries had experienced an economic slowdown at the beginning of the 1970s, and that they were understandably anxious to restore high levels of economic activity and employment as soon as possible. For this reason they were following highly expansionary monetary and fiscal policies. The degree of monetary expansion that occurred in some countries was increased by their efforts to preserve exchange rate levels that turned out to be unsustainable.

In time the consequence of these policies was a rapid increase in public and private spending in the major industrial economies, which was mutually reinforced through their international trade. Production surged ahead in almost all of them at roughly the same time. By 1973, much earlier than was generally anticipated, the strength of this widespread economic expansion was threatening to outrun world supplies of primary commodities, and the prices of many of them began to climb rapidly. For these and other reasons which I shall mention later, world prices of agricultural commodities were in the forefront of the advance.

In Canada too, the rapid expansion of both foreign and domestic demand was beginning to press against the limits of the economy's productive capacity in an increasing number of areas, again earlier than anticipated. I think it is fair to say that our high unemployment rates had created the impression of more available productive capacity than in fact turned out to exist as we later found when in the midst of relatively severe labour shortages unemployment rates stayed considerably higher than we had hoped could be achieved. In 1973 supply bottlenecks, order backlogs and delivery delays began to make their appearance in industries operating at full stretch. As these conditions spread, price increases grew larger, more frequent and more general both at the intermediate and final stages of production. A broadly similar pattern of developments occurred in other industrial countries of the world.

In the course of time steps were undertaken by the industrial countries to moderate the growth of domestic spending and provide resistance to the wave of inflation that was sweeping through their economies.

Developments on the demand side were not the whole story, of course. On the supply side, one of the earliest and most important sources of this inflation has been the growing food problem. Supplies of food grains and animal feeds have been substantially reduced in recent years. As I hardly need tell this audience, there have been poor harvests in some of the main producing areas, including of course our own prairies. No early relief from the shortfall in the supply of grains is in sight. In the face of a continually growing world demand, this has led to particularly steep increases in the prices of cereals and related foodstuffs. It has also led to the tragic fact that in some parts of the world more and more people are facing starvation.

A year ago a four-fold rise in the world price of oil added a new dimension to the problems already confronting the world. The consequences of the rise in the international oil price are really just beginning to unfold and it remains to be seen how well the world will cope with them. The balance of payments positions of many oil-importing countries have been thrown heavily into deficit. If oil prices remain where they are in relation to other prices, it will not be possible for many oil-importing countries to maintain satisfactory levels of economic activity even in the short run unless they go into debt on a scale that is completely unprecedented.

For some countries the possibility of borrowing to pay for oil is severely limited by the difficulty of finding willing lenders. This is what has given rise to the so-called recycling problem. Beyond what can be handled relatively smoothly by private financial markets, full recycling means channelling funds back to some countries that may not be able to carry the debt by themselves. This task will require international co-operation of a high order, for it is not reasonable to suppose that all of the funds channelled to the economically weaker countries can be repaid.

Even with reasonably effective recycling arrangements for the short run, however, the world will be left with a major unresolved problem, and that is the problem of how to reach a sustainable equilibrium between the main oil exporters and the rest of the world. A widely acceptable solution of this problem will be far from easy to achieve. The interim committee of Governors of the International Monetary Fund chaired by Canada's Minister of Finance will have an important part to play in efforts to deal with these problems.

During the course of 1974 the character of the inflationary process around the world has been changing. The pressure of excessive spending has slackened in most countries and is no longer the main driving force behind the continuing rise in prices. Some commodity prices have already fallen, and to an increasing extent, the continuing rise of final prices is now mainly a reflection of the upward push of costs. These

cost increases, in turn, largely reflect the efforts of various economic groups to protect themselves against the impact of current and past increases in prices and apparently in some cases to try to take out insurance against the possibility of even higher increases in the future.

At the same time the pace of economic expansion has turned sluggish or come to a temporary halt in most of the industrial countries. In some degree a pause of this kind was probably inevitable. Indeed, a pause was essential if the organization of production around the world was not to break down under the distortions of accelerating inflation. There is clearly some risk that the slowdown in economic activity may turn out to be rather more severe and prolonged than any individual country would wish to see or can avoid through its own policy actions. The risk on the other side is that countries may again over-react to the temporary weakness of their economies with an excessive dosage of fiscal and monetary stimulus, thereby ensuring even higher inflation rates two or three years from now.

In broad brush, then, this is where the world economy stands today and the route it took to get there.

In reflecting on economic developments over the past three or four years, I cannot help but sense that all over the world a common pattern of events has been emerging. In a period of economic slowdown, fiscal and monetary policies quite properly are adjusted to try to bring the economy back on the

path of expansion. But it takes time for the economy to respond to these measures and it is very difficult to wait patiently without adding more and more stimulus as time goes on. Excessive stimulus leads in due course to a boom in economic activity which is too rapid to be sustainable. By the time the need to moderate the degree of stimulus becomes apparent, it is generally long overdue. The result is periodic overloading of the economic system, the escalation of inflation and rising inflationary expectations. I do not suggest that this is the whole story of how we have come to overload our economies from time to time, but it is certainly an important part.

Overloading our economies puts us in the position of trying to do things that are basically incompatible. On the one hand, we are trying to operate market economies in which prices and incomes are to a large extent determined through highly decentralized decisions and the general price level is determinied by over-all supply and demand forces. On the other hand, we periodically run our economies so close to full stretch that in many areas of the market we are bound to encounter situations in which the supply cannot possibly expand rapidly enough to keep up with demand. The result is that those same market forces that we rely on set off new rounds of price increases. And then we wonder why no one has yet found the answer to the problem of inflation. If this is how we are going to run the system it is time we realized that no one is going to find the answer. There is simply no way in which market economies offering as much freedom of

individual action as those we are used to can continue to function properly if they are repeatedly overloaded with excess demand.

Experience is now providing us with hard evidence of the difficulties involved in operating an economy under inflationary conditions. You will recall that a number of years ago when the rate of inflation was still relatively moderate there was a continuing debate about how seriously the problem should in fact be regarded. On one side were those who took the view that the evils of inflation were greatly exaggerated, and that it was better to adjust to it and try to live with it than to face up to the costs of bringing it to an end. On the other side, it was felt by many that if we tried to reconcile ourselves to inflation the process would tend to accelerate over time, since the problem of keeping any given rate of increase in the price level from rising would, after a period of adjustment, become just as great as the problem of avoiding inflation in the first place. Theoretical arguments of this kind, however, are seldom overwhelmingly convincing and, as happens so often in the course of human affairs, we are learning the hard way.

Everyone knows about the redistributional effects of inflation which, serious as they are for those who have lost rather than gained, are nevertheless only part of the story. When the value of money begins to shrink rapidly but at varying and unpredictable rates, the potential damage involved goes well beyond the resulting haphazard and arbitrary pattern of gains and losses in real income and wealth.

The fact of the matter is that the effective functioning of modern industrial societies as we know them depends much more than is generally realized on reasonable predictability of the value of the monetary unit in terms of which contracts are drawn and savings and investment plans are formulated. The results of growing uncertainty about the future value of money can be seen in almost every area of economic behaviour. Rational planning for the future becomes more and more difficult and the risks of undertaking forward commitments -- other than those of the shortest possible duration -- become greater than ever. Examples abound throughout the world of severe distortions and imbalances that have been introduced into cost and price relationships and of the strains that these are causing.

What, then, are the options for policy in the present situation?

The first thing to be said is that, quite rightly, no country will choose to try the drastic remedy for inflation of deliberately creating whatever degree of slack is required to bring it to a halt in a relatively short time. As I have already indicated, there is though some risk that the current slowdown in world economic activity may go further and last longer than previous periods of cyclical weakness. This could happen because of the urgent need felt by some countries to reduce their balance of payments deficits and the interaction of the efforts of many countries simultaneously to contain

inflation. Fortunately, however, there is in all of the major countries a general awareness of the kind of policy responses that could lead to a major economic collapse and a strong desire to ensure that member countries of the international trading community refrain from such actions. Indeed, although some countries are restricted in what they can do about their balance of payments deficits, most of them have policy readjustments in train which are designed to limit further declines in economic activity and which will, I hope, lead before long to some renewal of economic growth.

On the other hand, I see no way out of the current predicament of industrial economies that will not involve, for the immediate future at least, both a continuation of inflation and a slower rate of economic growth than that experienced up until quite recently. Things have gone too far for that. The inflationary process has now acquired too much momentum. Since drastic remedies are not acceptable, the only reasonable course is to try to cool off inflation gradually over a period of years by running our economies at levels that involve continued expansion but that stop short of pressing against capacity limitations. It will be difficult to steer such a course but the stakes are high. The co-operation of all the various groups in society in limiting their demands to magnitudes that are consistent with some decline in inflation rates will be needed, and anything that can be done to encourage such co-operation will be useful.

I have deliberately discussed these broad economic policy issues in the context of the industrial countries as a group because they are common problems. Now I want to turn more specifically to the Canadian scene. In his budget last week the Minister of Finance dealt with fiscal policy and the fiscal position of the Government. I will focus my remarks on the recent evolution of monetary policy.

As you will remember, the opening months of 1973 marked the beginning of a gradual shift in the posture of monetary policy in Canada. The change was aimed at moving in an orderly way to more moderate and sustainable rates of monetary growth. Over the course of the next 18 months interest rates in Canada kept moving upward to progressively higher levels. This reflected the interplay of the Bank of Canada's less accommodative policy stance, the strength of the credit demands generated by a booming Canadian economy, and the pressure of sharply rising interest rates abroad.

Although it took some time, I believe we were successful in bringing about a change in the monetary climate that offered considerable resistance to a continuation of excessive demand pressure on the economy. This objective was reached without the disruptive effects of a "credit crunch", although the downward adjustment in bond prices last spring was certainly sharper than one would normally wish to see.

Until the latter part of the summer it was our judgment that the readings we were getting from the main

economic and financial indicators -- though suggestive of a gradual slackening of demand pressures in the economy -- did not yet add up to a persuasive case for a relaxation of the stance of monetary policy. During the course of the summer, however, the weight of the evidence was shifting. There were mounting indications that the growth of aggregate demand in Canada was slowing: although the outlook for plant and equipment expansion remained strong, housing starts were declining sharply and there were increasing grounds for expecting our exports to be affected by the developing weakness of economic activity in the outside world. In the monetary and banking field, private holdings of currency and bank deposits, including savings and time deposits, continued to expand quite rapidly, but year-on-year monetary growth as measured by the narrowly-defined money supply, currency and demand deposit balances, was falling to quite low levels. In recent months there has also been evidence that the demand for bank loans has moderated.

In the circumstances we reached the conclusion that the time had come for an adjustment in the posture of monetary policy. The high water mark for interest rates in this country was reached about three months ago, that is, towards the end of August, and since that time market interest rates have moved to lower levels. In some areas of the interest rate structure, particularly yields on Government of Canada securities, the change has been substantial. A sharp decline in interest rates in the United States contributed to the downward adjustment of

Canadian rates, but other important factors have been some easing of domestic credit demands and the operations of the Bank of Canada, which have allowed the chartered banks to restore some of their depleted liquidity. In recognition of the change in market interest rate levels the Bank of Canada reduced the Bank Rate on November 15th, the date on which the new Canada Savings Bonds were withdrawn from sale. Deposit and lending rate reductions have also been announced by the chartered banks and other private financial institutions.

This recent adjustment in monetary policy should not be misunderstood. It does not mean that we have suddenly abandoned the effort to help bring inflation under reasonable control by keeping the pace of monetary expansion within the bounds of moderation. That objective remains of paramount importance. What this policy adjustment does mean is that we have recognized the appearance of influences in the environment tending to weaken aggregate demand and real economic growth.

In our judgment, the aim of monetary policy should be to maintain rates of monetary growth that are consistent both with continued economic expansion and a slowing of the pace of inflation. Interest rates must be allowed to adjust -- upward as well as downward -- whenever this is required to keep the pace of monetary growth within these limits. While there will always be external influences beyond our own control, a willingness to act with patience and moderation is essential if we are to work our way back to a healthier balance in the economy.

NOT FOR PUBLICATION BEFORE 3:00 P.M. EASTERN DAYLIGHT SAVING TIME

September 22, 1975

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE 46TH ANNUAL MEETING OF
THE CANADIAN CHAMBER OF COMMERCE
SASKATOON, SEPTEMBER 22, 1975

Canada

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE 46TH ANNUAL MEETING OF
THE CANADIAN CHAMBER OF COMMERCE
SASKATOON, SEPTEMBER 22, 1975

When your President invited me early in the year to come to Saskatoon to address a luncheon gathering at this annual conference, I was very glad to be able to accept. The occasion has given me the chance to visit my native province again, which is always a pleasure, and it has given me a very welcome opportunity to hear views about our economic problems from many of your delegates and an even better opportunity to tell you how I feel about those matters that by virtue of my job are of particular concern to me.

Earlier this month the Bank of Canada announced an increase of 3/4 of one per cent in its Bank Rate, that is, from 8 1/4% to 9%. For several weeks prior to this announcement Canadian interest rates had been rising both in the short-term money market and in the bond market. Following the Bank Rate move the chartered banks and a number of other financial institutions announced increases in the rates that they charge for bank loans and mortgages and that they pay for savings and time deposits. There was also some further upward adjustment of market interest rates.

This recent increase in interest rates, and in particular the

Bank of Canada's part in it, has naturally attracted a good deal of attention. I would like to take this opportunity to review with you the reasons for our decision to raise our Bank Rate. That decision rests on two underlying propositions.

The first proposition is that it is very much in the public interest that the drift into deepening inflation in Canada be halted and reversed. A few years ago when the rate of price rise was relatively low there was a certain amount of debate about this proposition. However, now that we have been experiencing double-digit inflation there are few who would seriously question it, and very few indeed among those who have watched what has been happening in countries where the rate of increase in the price level has continued on up to figures such as 25 per cent a year. Nevertheless, I think that there is still a good deal of wishful thinking surrounding this matter and that there is an inadequate appreciation of the seriousness of the problem that we face. To put my first proposition another way, it is that the protection of the value of money is of prime importance to the future economic and social welfare of Canada.

The second proposition is that, whatever else may need to be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. Any programme that did not include this policy would be doomed to failure. There is no way of preserving its value if money is created on an excessive scale. In this country the job of keeping monetary expansion within reasonable bounds is the direct

responsibility of the Bank of Canada. I do not want to pause here to describe the techniques that are used to do that but I want to assure you that although the degree of control over short-run movements is not precise, the means available to the Bank to do this job are broadly adequate.

I want to emphasize that control over the money supply cannot be maintained unless the central bank is prepared to allow interest rates to move. I know that this may be a difficult point to grasp, but it is crucial to an understanding of why we have just had an increase in interest rates in Canada. It is simply not possible for the Bank of Canada to control the rate of monetary expansion while at the same time trying to hold interest rates to some fixed level. The reason for this is that the Bank of Canada cannot control the demand for money. That depends on the state of the economy and people's views about the future. If the demand for money strengthens the only options open to the central bank are to allow interest rates to rise or to resist the upward pressure on them by taking action to permit a larger increase in the money supply than would otherwise have occurred.

This brings me to the recent situation. In the past few months the demand for money and credit in Canada turned stronger, with the current and prospective credit demands of borrowers -- including the very large requirements of governments -- threatening to outrun the supply of funds savers seemed willing to lend or invest at the then prevailing interest rate levels. At the same time the growth of the money stock accelerated to rates

in excess of 20 per cent a year -- rates which, if allowed to continue, would lead in due course to an acceleration of the rate of inflation in Canada. In these circumstances the central bank had no responsible alternative but to let market interest rates move upward in response to the pressure of credit demands, and to adjust its own lending rate accordingly. This, in essence, was why the Bank of Canada decided to act as it did three weeks ago.

I am aware that many people find it difficult to understand why higher interest rates should be regarded as anti-inflationary, since an increase in the cost of borrowing immediately increases the costs of doing business and higher mortgage rates immediately add to the cost of housing. These immediate effects are undeniable, but they are only part of the story and not the most important part. The most important part of the story is that to react to rising demands for credit by permitting excessive monetary expansion inevitably leads in due course to higher rates of inflation. Experience here and in other countries proves this point beyond any shadow of a doubt. After extended periods of very rapid monetary expansion the result, invariably, has been substantially higher rates of increase in costs and prices.

In coming to its decision to raise the Bank Rate, I can assure you that we in the Bank of Canada were well aware of those features of our present economic situation that might point in the direction of avoiding any increase in interest rates at this time, and we certainly were not inclined to dismiss them lightly. But we had to weigh these considerations against the consequences of giving up any serious effort to control the growth of the supply

of money. To some extent this was a weighing of immediate consequences against longer-term consequences, but it was by no means only that. A powerful force that is feeding the inflationary fires in Canada right now is a widespread expectation of continuing, and even accelerating, inflation. What would be the effect on this inflationary psychology if the central bank were seen to be unconcerned?

The only other direct comment that I want to make on the recent increase in our Bank Rate is a brief reference to its exact timing. At first financial markets seemed surprised at the timing, but I think that they have now come to see clearly what lay behind it. The Government of Canada was on the eve of decisions about both a large new market issue of Government securities and the new Canada Savings Bond campaign. Since we in the Bank of Canada were convinced that a change in our Bank Rate could not be long delayed, it seemed desirable that the Government's new financing should be brought to market after our action rather than before it. The date of the Bank Rate announcement, September 2nd, was about the latest date that allowed financial markets a reasonable period in which to react.

I would like now to say a few words about some other features of our present economic situation which we have kept in mind in conducting monetary policy.

It is clear to everyone of course that, like other industrial countries, Canada has been passing through a recession. So far this country has escaped with a shorter and milder fall-off in activity than most of its

trading partners, although at the moment our industries are operating for the most part at levels well below capacity. Both here and in the United States, if not as yet in many overseas countries, there is accumulating evidence that the worst of the recession may now be behind us and that production is beginning to recover.

Unemployment has risen in Canada. In recent months it has been recorded as about two percentage points higher than it was at the peak of the boom in 1974. Moreover, our history suggests that any substantial decline in unemployment can be expected to lag behind any general recovery in economic activity by several months. One can note that the current rate of unemployment in Canada is a full percentage point below that in the United States and that Canada's arrangements for providing compensation to the unemployed are among the most generous in the world, but the fact remains that no one welcomes unemployment. The only acceptable goal for Canada is sustained high levels of employment. The question is how best to pursue that goal. The present problems of recession and unemployment both here and elsewhere can be traced directly in very substantial part to the excesses of the recent worldwide inflationary boom. We cannot expect to achieve any lasting solution to these problems by setting off yet another round of inflation fueled by excessive monetary expansion.

New housing construction in Canada also continues to be beset with a variety of difficult problems, many of which reflect the distortions generated in the intense inflationary boom of 1973-74. The strong demand during that

period for houses and apartments greatly inflated both the cost of constructing new housing and the prices of existing housing. While rents have been rising persistently, they have not kept pace with the cost of putting new rental accommodation in place. The result has been to make the construction of new rental units economically unattractive, at least for the time being, and few such units are currently being constructed except under subsidized programmes. In spite of this the level of housing starts in recent months has been running at annual rates well in excess of 200,000 units. The demand for mortgage money has tended to exceed the supply of the term deposit money savers were willing to make available through institutional channels even at relatively high interest rates. But the main thing I want to say about housing is that many of the current problems arise from the extent to which recent inflation has distorted normal cost, price and rent relationships. That situation will not be remedied by allowing inflation to continue at existing or even higher rates.

There is another feature of our economic situation that I haven't said much about as yet, and that is the continued steep upward trend of costs and prices. There are admittedly some special factors in areas such as energy prices and food prices but even after making allowance for these the rate of increase remains much too high. The current wave of inflation was not initiated by a marked acceleration of wage and salary increases. It was the other way around. It was the short but intense boom -- more intense here than in the United States because of the relatively greater importance of primary

products in our economy -- that gave rise to demands for higher rates of increase in labour incomes. But that boom ended some time ago and new wage and salary settlements continue to be disturbingly large. They have been running for the past several quarters at around 18 per cent per year on average, a rate of increase that is far greater than would be consistent with any diminution of our rate of inflation. It appears that for the most part employers have been passing these increases on to consumers in the form of sharply higher prices, and that all concerned act on the assumption that they will continue to be able to do so.

If one reflects on this situation in the light of the present levels of unemployment and unused productive capacity, one cannot help but wonder what is going on here. In our economic system the basic control over the level of prices is and always has been the willingness of the market to pay them. It's obvious that improved productivity can offset very little of the cost of current wage and salary increases since the long-term average increase in output per worker in this country is only 2 1/2 per cent per annum. In many cases, in fact, those involved in both the private and public sectors seem to be incurring costs at rates that foreshadow an accelerating increase in inflation. How is this expected to work? Are fiscal and monetary policies being counted on to be sufficiently expansionary to accommodate an accelerating increase in costs and prices? Is the central bank expected to create enough money to finance whatever rate of inflation emerges?

Expectations of this sort are clearly quite inconsistent with any

possibility of good economic performance over time. I do not want to encourage their development by seeming to be unconcerned when the rate of monetary expansion in Canada tends to be excessive. Let me therefore say a further word about rates of monetary expansion in Canada.

Over a period of two years ending in the second quarter of 1973, a period in which unusually high rates of monetary expansion occurred around the world, the public's holdings of currency and demand deposits -- the main forms of money used for making payments in Canada -- increased at an average rate of no less than 15 per cent a year. By comparison, an average rate of no more than 5 per cent a year would have been high enough to accommodate the growth in production of goods and services in Canada at the long-term trend rate if the price level had remained stable.

The Bank knows perfectly well, of course, that over recent years an underlying rate of inflation has been built into our economy which is now much too high to be eliminated at all quickly by suddenly reducing the rate of monetary expansion to anything like such a low figure. The consequences for economic activity would be much too disruptive in the short run, so that whatever progress is to be made in moderating the rate of monetary expansion in Canada must be achieved gradually over time.

Some moderation has occurred. Over the two years to the second quarter of 1975, the average rate of growth of currency and demand deposits in Canada has been about 10 per cent a year. Since then the rate of money supply growth has bounced back up to unusually high figures but as I have

explained we have now taken the steps that we think will ensure that this excessively high rate does not continue.

When you look at the cyclical aspects of the current economic situation, those of you who have watched economic and financial developments closely for as long as I have must be struck as I am with a sense of déjà vu. We have been here before. On previous occasions we have generally ended up, for all sorts of plausible short-term reasons, by turning economic recovery into an inflationary boom. This time round, it seems to me, we would be well advised to take a long look backwards at where we have been making our mistakes, together with a long look forward at where we want to be two or three years from now -- and how we propose to get there.

The last time this country began to emerge from recession into recovery with a persisting problem of substantially escalated labour costs was as recently as 1970, only five years ago. In those days a policy aimed at trading off a bit more inflation in order to get a bit more employment was still the conventional economic wisdom. We now know what happened. Three years later we all found ourselves participating in the most virulent worldwide inflationary boom of living memory under peacetime conditions. The boom didn't last much more than a year before signs of spreading recession began to appear in one country after another even before the shock of oil prices. And now we find ourselves back at square one with higher unemployment rates, with higher underlying rates of cost and price inflation, and with higher interest rates.

For more than 20 years almost every country in the western world has given rapid growth and high employment much higher priority in its policies than the preservation of the value of money. This approach worked well for quite a while, but it won't work well any longer. The loss of confidence in the value of money that has resulted from these policies has now become so great almost everywhere as to threaten the effective functioning of our existing economic, social and political institutions. We now have no option but to contain inflation and inflationary expectations if we are to have any realistic hope of achieving sustained economic growth.

You will have realized by now that I am not offering to you views on all the things that can or should be done to grapple constructively with Canada's various economic problems. My primary responsibility is to try to get monetary policy right, and I've explained today what I think that means. You can be confident that the Bank of Canada will permit a rate of monetary expansion that by any reasonable standard is sufficient to meet the needs of a good economic recovery with some moderation in the recent pace of inflation. You can also be confident that we shall be on guard against rates of monetary expansion that reinforce inflationary tendencies. I know, of course, that many things other than monetary policy have also to be right before the economic system will work well. I hope that a sober appreciation by Canadians of the seriousness of our economic problems will call forth sufficient will to co-operate in their resolution.

NOT FOR PUBLICATION BEFORE 1:30 P.M. ATLANTIC DAYLIGHT SAVING TIME

JUNE 23, 1976

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO THE FREDERICTON CHAMBER OF COMMERCE
FREDERICTON, N.B., JUNE 23, 1976

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the
Fredericton Chamber of Commerce
Fredericton, N.B. June 23, 1976

May I begin, Mr. Chairman, by saying that I am most grateful for the invitation to speak to the Fredericton Chamber of Commerce on the same day as the Board of Directors of the Bank of Canada is meeting here.

The Board usually holds its meetings at our head office in Ottawa but it has been our policy to arrange periodic meetings in other parts of Canada. Directors come from right across the country -- two from Ontario, two from Quebec and one from each of the other eight provinces. Other members of the Board are the Deputy Minister of Finance, the Senior Deputy Governor and myself as Chairman. Meetings like this one give the Directors of the Bank the opportunity to see and hear something at first hand of economic conditions in the various regions of Canada. I wouldn't, however, want you to think that back in Ottawa we are by any means totally ignorant of events in New Brunswick. Quite apart from other channels, our Director from your Province, Mr. John Burchill, sees to it at our Board meetings that we are well informed. We are indebted to him for the invitation

to meet in Fredericton and for many of the arrangements that have been made for us. We are delighted to be here and we look forward to talking with many of you. We expect to leave with a better understanding of your circumstances and problems, many of which are certainly matters of serious concern.

At the same time I should make it clear that the operations of the Bank of Canada, which are essentially directed at controlling the rate of expansion of the money supply in Canada as a whole, necessarily have an impact that is national in scope. The major way in which our activities can be helpful to your Province, or to any other region, is in the extent to which they ensure that its economic activities are carried out within the framework of a strong and expanding national economy.

Today I want to say something about the nature of the problems facing our economy and about the kind of public policies that we need in Canada, both to permit the current economic recovery to continue and to provide a sound basis for sustained growth in the future. In the course of my remarks I shall concentrate on monetary policy since that is the area in which the Bank of Canada has responsibility.

Let me begin by reminding you of some features of the economic situation in Canada as they were last summer. Prices were continuing to rise at rates appreciably in excess of 10 per cent a year.

Although the average increase in real output per worker is usually around 2 per cent a year, rates of pay were being inflated by increases averaging in excess of 15 per cent a year, with many settlements substantially above that figure. A gap of well over $4 billion a year had opened up between our spending on foreign goods and services and the export earnings we were generating to pay for them. Our national unemployment rate had risen to around 7 per cent of the labour force even though the downturn in economic activity from which Canada was just beginning to recover had been much less severe than in the United States and many overseas countries. At the same time Canada was entering the recovery period of the business cycle with a significantly higher continuing rate of inflation than that of its main trading partner.

There were a number of related reasons for anxiety about how these difficulties could be overcome.

One reason was that the standard policy prescription followed in past recessions in order to bring the economy back to more normal levels of production and employment was unlikely to work well in the situation we found ourselves in last summer. In previous recessions when people still had little experience of rapid inflation, the general policy approach followed in Canada and other countries had been for governments to increase their expenditures substantially without a corresponding increase in tax revenues and sometimes indeed with

tax reductions; meanwhile the central bank would expand the money supply fast enough to prevent this increase in government borrowing from pushing interest rates upwards. Looking back now, it seems clear that excessive reliance around the world on these highly expansionary policies in order to get quick results in the short run has been one of the main reasons for the rising trend of inflation rates over the longer run. By last year, with inflation running at double-digit levels, that approach involved far greater risks than ever before.

Such policies would certainly have increased the total amount of spending by Canadians, and no doubt some part of this additional spending would have encouraged higher levels of production and employment in Canada, at least for a time. The risk was, however, that much of this additional spending would simply lead to still higher costs and prices in this country and to still higher imports from abroad. This was particularly so at a time when Canadians generally had come to fear that rapid inflation was likely to continue or even accelerate, and were anxiously seeking to gain as much protection as possible from its impact through substantial increases in their own prices and money incomes.

Another reason for being concerned was that if costs and prices in Canada continued to rise at rates as high or higher than those we had already been seeing for some time, Canadian industry would soon

find itself in a steadily worsening position in terms of its ability to meet foreign competition both here in Canada and in export markets. This was not the first time in our history that more rapid inflation in Canada than in the United States had posed this particular danger, but invariably in the past we had not let a situation of this kind continue for long. This is the main reason why the external value of the Canadian dollar has remained as close to parity with the United States dollar as it has for so many years.

There is of course the possibility, in theory at least, that a continuing higher rate of inflation in Canada than in the United States could be accommodated by a movement over time of the exchange rate, but it would be a serious error to suppose that such accommodation would work smoothly. One has only to look at the experience of other countries to see how disruptive the movements in exchange rates can be between countries with appreciably different patterns of inflation. From the point of view of a country's foreign trade it is much more sensible to aim for at least as good, and preferably better, performance in domestic costs and prices than in the countries with which it trades. It is interesting, and in my view instructive, to observe that after all the movements of the foreign exchange rates of many countries in recent years, it is those countries with the best records of dealing with domestic inflation that have emerged as being in the strongest positions in international trade.

By far the most important reason for being alarmed about where we were heading, however, was that this particular upsurge of inflation was simply the latest and most severe of a number of such episodes, each of which had turned out to be more serious than the last. Only two or three years earlier few Canadians would have thought it possible that they would be witnessing double-digit inflation in 1975 in the midst of world-wide recession. If we continued to follow much the same sort of policies that had permitted episodes of this kind to occur in the past, what was to prevent the rate of inflation from reaching, say, 20 to 25 per cent a year in the next such episode? Given the degree to which confidence in the future value of money had already been shaken in Canada in recent years, how could our market economy possibly be restored to any kind of lasting health and vigour in the absence of convincing evidence that inflation not only could be but most certainly would be brought under firm control and kept under firm control in this country?

These, then, were in my view the main grounds for concern about the course that the Canadian economy seemed to be on last year just prior to the launching of the anti-inflation programme.

The programme is now well into its first year, and although it is still too early to judge what degree of success it will ultimately achieve, I believe that it continues to have a good chance of bringing

the rate of price increase down very substantially over the next year or two. Encouraging progress has already been made. At the absolute minimum, it is surely fair to say that the programme has already gone a long way towards calming the more extreme manifestations of the inflationary psychology that gripped Canada not so many months ago. At the same time the economy has continued to grow -- not as rapidly as in the early stages of past recoveries, perhaps, but then that was hardly to be expected in present circumstances.

As you know, the anti-inflation programme depends crucially on the fiscal policies of the federal and provincial governments and on monetary policy to keep the growth of public and private spending within moderate limits, while at the same time it supplements these policies by providing a mechanism for intervening directly in price and income decisions. I don't propose to say very much today about these other important elements of the over-all programme, but I would like to say something about the role of monetary policy.

Perhaps the place to start is to remind you that the main job of the Bank of Canada is to regulate the rate at which the total quantity of money in this country is increased over time. A growing economy needs a growing stock of money, but if the quantity of money in the hands of the public is allowed to expand too rapidly, sooner or later its value will fall. The value of money simply reflects the quantity of goods and

services that you can obtain in exchange for it -- that is, it is the obverse of the price level. When the price level goes up, the value of money goes down. The control of the quantity of money is therefore an essential element in the control of inflation.

The Bank of Canada has been making a determined effort to keep the money supply growing at a more moderate and steadier pace than in the past. The basic principle underlying the policy of the Bank has been to permit the money supply to grow at a rate consistent with continued economic expansion provided that this is accompanied by some slackening of the rate of inflation. For reasons which I have discussed elsewhere, the particular monetary aggregate whose growth rate the Bank of Canada has tended to regard as the most useful one to focus on for control purposes has been currency plus demand deposits at banks -- the main forms of money used directly for making payments in Canada.

Last autumn I gave some indication in public of the general range within which we were trying to keep the growth rate of the money supply during the current period dating from the second quarter of last year. I said that in our view it would be inadvisable for the time being to aim at reducing the trend rate of monetary growth below 10 per cent a year, but that on the other hand a rate of growth as high as 15 per cent a year would be much too high. In the event, it now looks as though the

growth of the money supply over the latest 12-month period measured to the second quarter of 1976 will be close to 10 per cent, that is, at the lower end of the range announced last fall. I regard this outcome as satisfactory, having regard both to the recent performance of the economy and to the need to make progress toward the achievement of the objectives of the anti-inflation programme.

Not everyone is impressed by the fact that for some time now the underlying growth rate of currency and demand deposits in Canada has been kept down to a figure of around 10 per cent a year. They point to the fact that the recent growth rate of currency and demand deposits in the United States has been only about half that figure, that is closer to 5 per cent a year. It should be noted, however, that a more accurate comparison of the growth rates of the main forms of money used for transactions purposes in the two countries requires the inclusion in the Canadian figures of chequable savings accounts on which interest is paid -- a form of money still widely used for making payments in Canada but one that is much rarer in the United States. On this basis the comparable Canadian figure is not 10 per cent a year but 7 per cent. There are other relevant differences between financial developments in Canada and the United States, and I do not regard recent U.S. experience as indicating that the rate of monetary expansion in Canada in the last year has been too high.

I would be the last to deny, of course, that the growth rate of the money supply in Canada on either of the definitions to which I have referred is still too high to be consistent both with a stable price level and with continuing real growth of the economy at its long-term trend rate of increase of close to 5 per cent a year. The trouble is that widespread expectations of rapid and continuing inflation are still reflected in many on-going arrangements and contracts in our economy, so that while inflation can be geared down gradually over a period of years, there is simply no way of bringing it to an abrupt halt without having a very disruptive impact on economic activity and employment in Canada.

A notional timetable for gearing down Canada's inflation rate was implicit in the Government White Paper issued last October outlining the main features of the anti-inflation programme. There the possibility was envisaged that the rate of increase in the price level in Canada would be reduced by roughly two percentage points a year over a three-year period. This would bring our inflation rate next year down to around 6 per cent, and in 1978 down further to around 4 per cent.

The possibility of slowing down inflation in Canada in accordance with this general timetable is neither an unrealistic hope nor an overly-ambitious goal. It is, in fact, about the minimum that we must and can achieve if our economy is to become healthy and prosperous

again on any lasting basis; and until it is achieved, it must in my view continue to have the highest priority. A programme that attempts to gear down inflation over a three-year period is bound to require a great deal of patience on the part of everyone. But the consequences of a demonstration of failure to deal adequately with our current problem of inflation would be most serious in terms of its effect on confidence and on expectations of future inflation. There is simply too much at stake in the effort to which we are now committed to allow it to fail. We are on the right course, and we must stick to it with all the patience and determination we can muster until we have achieved what we set out to do.

With the broad objectives and timetable of the anti-inflation programme in mind, what sort of monetary policy should Canadians expect over the period ahead?

First, we intend to press ahead with the gradual slowing of the pace of monetary expansion that is essential to the success of the anti-inflation programme as a whole. As I have already noted, the growth of the money supply in the form of currency and demand deposits has been kept down to about 10 per cent over the past year. Looking ahead it is clear that the limits of the target range for monetary expansion announced several months ago are becoming outdated and that before long a somewhat lower range should be regarded as the appropriate one to aim at. The announcement of a lower range should not necessarily be

regarded as signalling a change in the current setting of monetary policy. That would only be necessary if the trend rate of monetary expansion prior to such an announcement had been outside the new range.

The second point I want to make has to do with the implications for interest rates of the gradual slowing of the pace of monetary expansion in Canada that we are determined to see. I particularly want to question the tendency of some people to assume that progressively lower rates of monetary expansion must necessarily involve progressively higher rates of interest. This is by no means the case. It is true that so long as the pace of inflation fails to slacken sufficiently the Bank of Canada cannot take action to moderate excessively rapid monetary expansion without being willing to see temporary increases in short-term interest rates. We have faced up to difficult decisions of this kind in the past, and should the necessity arise in the future we would do so again. But to the extent that the rate of inflation in Canada falls, the money value of national income will rise less rapidly and so will the amount of money required to carry on business. It is therefore within the realm of possibility that receding inflation will permit a gradual moderation of money supply growth without the need for significantly higher interest rates than we have at present. Indeed, in an atmosphere of growing confidence that inflation was being brought under control and would be kept under control, interest rates could over time be expected to begin declining, especially long-term

rates which now clearly include a sizeable inflation premium. I am offering no forecast whatsoever of how interest rates will in fact move in the months ahead, but I do believe that over the longer run, lower rates of inflation, lower rates of increase in the money supply, and lower interest rates are mutually compatible objectives.

My third point has to do with concern that the economic recovery that is now underway in this country could falter as a result of the effort that is being made to moderate the trend of money supply growth.

In this connection I remind you that the Bank of Canada has no intention of cutting back the growth of the money supply at all suddenly or drastically. Given time, our economy can adjust in an orderly way to a gradual lowering of the rate of monetary growth through a gradual reduction in the rate of inflation. Hand in hand with receding inflation we can expect continuing increases in economic activity, with strong support coming from the economic expansion which is now being experienced by virtually all industrial countries. But if the rate of monetary expansion should begin falling away further or faster than we think the economy can safely adapt to, I can assure you that the Bank of Canada will be alert to the need for prompt corrective action.

I began my remarks today by referring to the need to pursue economic policies that will provide a sound basis for economic growth in

the future, and later on I spoke of the time and patience that this approach will require. It is of course very difficult to resist the temptation to seek quick remedies to our problems, even at the cost of building up more serious difficulties for ourselves in the future. But surely if there is one lesson to be learned from our experience in recent years, and that of other countries, it is that a longer-run approach to policy is essential, that we must keep an eye on the far horizon, on where we want our economy to be a number of years from now. I am encouraged by the signs I see that we are learning that lesson.

NOT FOR PUBLICATION BEFORE 1:30 P.M. EASTERN DAYLIGHT SAVING TIME

September 23, 1976

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE BUSINESS OUTLOOK 1977 CONFERENCE
OF THE CONFERENCE BOARD IN CANADA
MONTREAL, SEPTEMBER 23, 1976

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the
Business Outlook 1977 Conference
of The Conference Board in Canada
Montreal, September 23, 1976

Before beginning the preparation of my remarks for this luncheon meeting I looked over the programme for today, especially the session this morning. I noted that the agenda covered the economic and financial outlook for both the United States and Canada. My initial concern that by lunch time there would be nothing left for me to talk about soon gave way to relief that, with so many astute forecasters in your midst, there would clearly be no need for me to try to tell you what the near-term business outlook is. What I would like to do instead is to say something about why the near-term outlook is not better than it is, to reflect in a general way on how things are going in our economy, and to explain very briefly the rationale behind the monetary policy we are following.

The Canadian economy is passing through a difficult period. It is in fact a difficult period for most countries. Not surprisingly, the task of trying to restore more satisfactory levels of economic activity and employment while at the same time gearing down the rate of inflation is turning out to be far from easy. This is true no matter where you look.

It is also a very frustrating period for many Canadians. One is reminded of what it's like having to live on a strict diet in order to deal with a weight problem. Like all weight-watchers we find that the need to observe moderation in our eating habits makes us feel depressed and irritable. It is bad enough to have to keep resisting the temptations of the refrigerator when we feel hungry; it's even more discouraging to find out from the bathroom scales how slowly we seem to be getting back in shape.

To get back to our economic situation, it is important that our frustrations not be allowed to obscure the fact that it is inflation itself that is the primary obstacle to the recovery of our economic health, that is, to the achievement of widespread and

enduring prosperity. I regard this point as important and not always sufficiently appreciated. Expressions of concern by central bankers about inflation are sometimes represented to be a kind of blinkered phobia about the value of money as an end in itself, a fixation sorely lacking in compassion for the welfare of people. I assure you that this is not so. My concern about inflation arises from the harm that it does to the welfare of people. The case for fighting inflation rests on the fact that inflation threatens what people want. It threatens sustained economic prosperity, political stability and social progress. It threatens economic growth, job creation, productivity and rising living standards, and it threatens a sensible balance of trade and capital flows between Canada and other countries. That is why inflation matters. That is why it must be fought. That is the proposition that underlies anti-inflation programmes. That is the conviction that underlies the monetary policy of the Bank of Canada.

My main point, then, about the economic outlook for Canada in the years ahead is that it depends very much on how

successful we are in containing inflation. To the extent that we succeed, the prospects for economic prosperity will improve. To the extent that we fail, the prospects for economic prosperity will deteriorate. You will realize of course that in talking about the economic outlook in these terms I am thinking of a longer period than the next six to twelve months on which business outlook sessions usually focus. I am thinking of the next two or three years and beyond. But what things will be like in Canada in two or three years is surely even more important than what they will be like in six to twelve months. Whatever our more immediate problems, we must not lose sight of the longer-term horizon.

In this country we are tackling inflation by a process of gradualism. The aim is to reduce the rate of inflation by something like 2 per cent each year over a period of years. It is an obvious disadvantage of gradualism as a way of dealing with any difficult problem that the pains of adjustment continue over a longer period. It would have been possible to try to do the job more quickly. The pain might be over sooner, but it would

surely be more intense. Would Canadians have liked that better? I doubt it.

It was also decided to support the central role of fiscal and monetary policy in the attack on inflation with a system of direct controls. Because of the extraordinary rate at which costs and prices in Canada were accelerating a year ago when that decision was taken, I thought that it was constructive, and I have not changed my mind. I regard many of the difficulties that the Anti-Inflation Board has encountered as evidence of how difficult it would be to leave the task of gearing down inflation, even at the modest rate we are attempting, solely to monetary and fiscal policy.

After acknowledging all the difficulties and frustrations involved in the present situation, is the effort to restore Canada's economy to a healthier state getting anywhere? Is there anything in the picture from which we can draw encouragement?

Turning first to the international economic scene, I think it is fair to say that we have witnessed a quite remarkable

change for the better. Not much more than a year ago, you will recall, the world's industrial countries were still in the grip of both the most severe recession and the most virulent inflation of the post-war period. In a few countries, notably the United States, the trough in economic activity seemed to have been passed and a rebound appeared to be underway, though one of unknown strength and staying power. In many other countries, however, there were still few signs that a similar turning-point was even imminent, let alone that it had been reached. Meanwhile costs and prices were continuing to push on upwards almost everywhere at double-digit rates.

Today the economic scene around the world looks very different. With only a few exceptions the industrial countries generally now seem to have moved well into the expansionary phase of the world business cycle. For a time the strength of the rebound in economic activity in some of the major countries like the United States, Germany and Japan took most observers by surprise. More recently, the pace of expansion has slackened considerably, and as usual this has raised some questions about

the vigour of the recovery even though the earlier pace was clearly unsustainable.

On the world inflation front there has been a marked decline in rates of increase in costs and prices throughout the industrial countries, and perhaps an even more striking improvement in the underlying climate of expectations. Last year's doubts about whether much improvement could be anticipated in the near-term outlook for inflation were too pessimistic. The question now is the extent to which the intervening gains will continue.

For my part, I take some encouragement from the degree to which popular attitudes in many countries today seem to have shifted in favour of firm policy action to restore and maintain a more stable price environment. I think this is reflected in the kind of monetary, fiscal and other policies currently being pursued in some of the world's largest industrial countries, and in the degree of continuing public support these policies appear to command.

This is one of the reasons why I feel reasonably confident that the world economy is not about to head back into renewed double-digit inflation propelled by an overly-strong world-wide boom in economic activity of the kind we saw in 1973. But it is not the only reason. This time round we do not have, as we had during that period, the threat of massive monetary expansion on the part of major countries seeking to prevent their exchange rates from strengthening in the wake of the collapse of the Bretton Woods system of fixed parities. And this time round we have much less reason to fear an extraordinary upsurge in world prices of foodstuffs, industrial materials, or energy supplies.

If this reasonably optimistic view about the risks of a resurgence of world inflation is at all near the mark, it seems to me that the chances look promising for a relatively long-lasting, moderately-paced and orderly period of world economic expansion. This would provide a favourable international environment for Canada's efforts to put its own house in order.

Let me remind you of the situation we in Canada found ourselves in a year ago. During the recent downswing in world economic activity we had experienced smaller declines in output and employment than almost any other country, but the price attached to our good fortune in this respect was a much more serious problem of cost inflation here than in many of our trading partners -- notably the United States -- and a very large current account deficit in our international balance of payments.

I know that in the eyes of many Canadians the degree of progress made to date in getting our inflation under control is regarded both as doubtful and disappointing. Those who take this view point to the fact that the much slower rate of increase in the Consumer Price Index over the past year largely reflects the behaviour of food prices, which they attribute less to the anti-inflation programme than to the vagaries of supply. They also point to the fact that in spite of their clearly moderating trend, wage and salary settlements are still outrunning any reasonable allowance for productivity improvement by a substantial margin.

My own view of the matter is that the underlying situation and outlook with respect to costs and prices in Canada has improved considerably over the last year. I base this belief mainly on the contrast I see between the rampant inflationary psychology that was so much in evidence in Canada a year ago, and on my own reading of the current attitudes and expectations of most Canadians with respect to inflation. A year ago it was possible to believe that inflation was so far out of control in Canada that almost any price or income increase seemed within the bounds of possibility. Today, there is, I believe, a growing awareness on the part of the public that the tide of inflation in Canada has definitely turned and is now receding. There is also, if I am not mistaken, growing awareness of the damaging economic and social consequences of severe inflation.

So far as the pace of Canada's economic recovery is concerned, I would not pretend that it has been particularly vigorous to date when judged in the light of comparable periods of strongly rebounding economic activity in the past. On this occasion, however, a rapidly-paced recovery was surely not in

the cards given the mildness of the earlier downturn in Canada and the need to bring our inflation under firm control. My own judgment is that in the circumstances we have not done too badly so far.

I should like to conclude by focusing more directly on the role of monetary policy in the present situation.

The guiding principle of monetary policy has been and is to bring about a gradual reduction over time in the rate of growth of the money supply, an approach that will accommodate a reasonable rate of real economic growth accompanied by progressively lower rates of inflation. No set of policies designed to bring inflation under control could possibly succeed without a moderation of the rate of monetary expansion. If the underlying trend of inflation continues to moderate, a monetary policy of this kind will not stand in the way of a good rate of economic growth -- nor, indeed, need it stand in the way of lower interest rates. If, however, the underlying trend of cost and price increases were not to continue to moderate along with the rate of

monetary expansion, the situation would be more difficult. While I do not believe the Bank of Canada should be rigid in the implementation of monetary policy, neither do I believe that it should simply adjust that policy to accommodate whatever rate of inflation turns up.

In stating its monetary growth targets the Bank of Canada has followed the practice of expressing them in terms of a relatively narrow definition of the money supply, that is, currency and demand deposits. I don't propose to take time on this occasion to go into all the reasons for the choice of this particular aggregate, but I do want to assure you that the reasons are strictly pragmatic. Some people would prefer a much broader aggregate, and I would not question that the broader aggregates are of interest, but I am still inclined to the view that for operating purposes a narrower definition is a more useful guide.

Last fall I indicated that we were aiming, for the time being, at an annual growth rate for currency and demand deposits of not less than 10 per cent a year, measured from the average

level for the three months ending June 1975. At the same time I indicated that I would regard a growth rate of 15 per cent a year as unacceptably high. As of March of this year the actual growth rate measured from this base amounted to roughly 12 per cent annually. A few weeks ago we announced a new and lower target growth range for this definition of the money supply of 8 to 12 per cent a year measured from its average level for the three months centered on March 1976. Looking to the future we have also stated our intention of further reducing the growth rate of currency and demand deposits over time in line with receding inflation.

The response to our announcement of lower monetary targets and the indications of support for monetary policy have been very good even though our action was not universally acclaimed. Some have wrongly concluded that in announcing lower targets we were aiming at an increased degree of monetary restraint through higher interest rates, but that misunderstanding has not been widespread. Most people seemed to recognize that it did not represent a basic change in policy but rather an up-dating

of the course that had been charted some time ago. Financial markets were expecting our announcement and were not unsettled by it. In fact I believe the recent behaviour of the long-term bond market provides some indication of growing confidence that we are making progress in the fight against inflation.

This brings me to the end of what I want to say today. In conclusion I will simply repeat my main theme, namely, that the business outlook over the medium term is heavily dependent on getting our prices and costs on-side and that the Bank of Canada is going to play its part in that process.

T FOR PUBLICATION BEFORE: 7:30 P.M. ATLANTIC DAYLIGHT SAVING TIME
6:30 P.M. EASTERN DAYLIGHT SAVING TIME

MAY 12, 1977

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO THE
HALIFAX BOARD OF TRADE
ANNUAL DINNER MEETING
HALIFAX, N.S., MAY 12, 1977

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the
Halifax Board of Trade
Annual Dinner Meeting
Halifax, N.S., May 12, 1977

I want to begin by expressing my pleasure at being here for the 225th Annual Dinner Meeting of the Halifax Board of Trade. To have been operating since 1750, to be the oldest "Association for the Benefit of Trade" in North America and the British Commonwealth, is an impressive and proud record indeed. Now I know what economists mean by the "long run". I extend my warmest congratulations to you and I want you to know that I feel greatly honoured to have been asked to address you on this occasion.

There is another reason why I am glad to be in Halifax for a couple of days. In the Bank of Canada we do our best to keep abreast of economic developments in this part of the country, and we are greatly assisted in this endeavour by our director from Nova Scotia, Mr. Bill Mingo, but I am nevertheless pleased to have this opportunity to have a close, if quick, look for myself and to talk to some of you on your home ground.

Regional economic problems in Canada are difficult enough at the best of times, but they become even more difficult when the national economy is in trouble, as it is today. The Maritime region is feeling all too acutely the impact of escalating energy costs, painful levels of unemployment, and pervasive and persistent inflation. Fortunately, there are some promising developments as well. But the fortunes of this area are bound up to a large extent with those of the country as a whole, and I would like to address my remarks mainly to our common national problems. I might say that I particularly welcome a chance to explain to you how it was that the Bank felt it appropriate to reduce its Bank Rate again last weekend -- the fourth reduction since November -- even though, as anyone who noticed my recent annual report will be aware, I continue to regard inflation as a most serious problem.

The particular points I want to focus on tonight are three in number. First, I want to explain what, in my view, is the essential nature of the problem that we face today in getting the Canadian economy to function satisfactorily. Then I want to talk about what has to happen if the problem is to be resolved. Finally, I want to say a word about how monetary policy can be expected to contribute to the solution of the problem.

To begin with, then, what has gone wrong with our economy? How is it that after two years of recovery from the low point of a cyclical

slowdown in activity we are still facing a combination of rather sluggish economic growth, weak investment, high unemployment, a large balance of payments deficit on current account financed by heavy foreign borrowing and yet at the same time a continuing, only partly subdued, upward push of our labour costs and prices?

Not so many years ago this would have been regarded as such an unlikely combination of problems as to be virtually unthinkable. An economy might have problems of slow growth, high unemployment and excess capacity, but if so it was unlikely to be suffering from any significant degree of wage and price inflation or to be drawing heavily on other countries to supplement its own production of goods and services. Alternatively, an economy might have an inflation problem and a large balance of payments deficit, but if so it was unlikely to be experiencing slow growth or high unemployment.

Put very simply, the belief was that a country could have either an unemployment problem because not enough money was being spent in the economy, or an inflation problem because too much money was being spent -- but not both problems at the same time. There are still people around today who are reluctant to give up this familiar view of how the economy works, and who would have us shut our eyes to one or the other aspect of what has now become, to all intents and purposes, a single interrelated problem.

It is the interrelation of unemployment and inflation that is, in my opinion, the most important single fact in the current Canadian economic scene. We have as much unemployment as we have now primarily because we have had so much inflation of costs and prices. The rate of cost and price inflation has been coming down but it is still too high and it is standing in the way of a lasting solution to our unemployment and balance of payments difficulties. It no longer makes sense to think in terms of giving priority to fighting inflation <u>or</u> to fighting unemployment. Success in dealing with inflation is essential to success in dealing with unemployment. I put emphasis on resisting inflation because I want to see a sustained increase in productive employment in this country. I put emphasis on resisting inflation because I think that the gravest longer-term threat to employment and to the economic well-being of Canadians is the risk that we fail to deal effectively with inflation.

If, then, it is essential to find a way of dealing with inflation, it seems to me useful at the outset to distinguish between those factors which set off an outbreak of rapid inflation and those which keep it going long after the original causes have disappeared. The onset of double-digit inflation a few years ago was in large part attributable to well-intentioned but overly-expansionary economic policies on a world-wide basis that generated excessive demand pressure on productive resources -- a situation compounded by special factors such as poor grain harvests and

the sharp rise in oil prices. However, although the pressure on productive resources subsided some time ago with the slowdown in world economic activity, inflation continues, although at a reduced rate in most countries.

What keeps it going? No doubt there are a number of reasons, but I believe the most important of these is the widespread expectation that high rates of inflation are here to stay. This expectation now seems to be built into our economic behaviour so firmly that wages and prices keep being pushed up even when labour and product markets have been relatively weak for rather a long time. It used to be said that in a modern economy there is generally strong resistance to any reduction in the absolute level of wages and prices. Now it might be more accurate to say that it is the rate of increase of wages and prices that seems to be subject to this downward rigidity. There was already some evidence to support this proposition at the time of the 1970-71 recession, which made scarcely a dent in the relatively high average level of wage settlements in Canada right through from 1966 to 1972. To give a more current example, in recent months the rate of price increase in the United States seems to have stopped declining for the time being even though levels of unemployment and unused capacity in that country are still relatively high. Clearly, it will be no easy task for the new U.S. Administration to achieve the goal it has set itself of getting the inflation rate down to 4 per cent by the end of 1979.

A major reason why people continue to act on the assumption that high rates of inflation are here to stay is that they have become very skeptical that disinflationary policies will be pursued long enough to be successful. They doubt that there is enough will to deal effectively with inflation. The resulting expectation of continuing inflation, through its influence on wage and price behaviour, is itself a cause of continuing inflation which, in turn, perpetuates the expectation -- a vicious circle. Progress in reducing inflation is correspondingly slow and unemployment remains high because we price ourselves out of the market. If, in the circumstances, governments and central banks relax their efforts to control inflation, this only serves to confirm the public's view that skepticism is justified.

The problem of persisting inflation is not unique to Canada, but we have the additional problem that for some time now our domestic costs and prices have been rising faster than those of the United States, our chief trading partner and competitor. At the margin we are still in danger of further loss of competitive position, even after the recent downward adjustment of our exchange rate. I say at the margin because our merchandise exports are, after all, running at an annual rate of over $40 billion. But even this high rate has not been enough to keep our deficit on goods and services transactions with other countries from being in the $4-5 billion range. There are many other economic and social reasons for wishing to have a non-inflationary economy, but the need to earn our

living in competition with other countries without a continuing depreciation of the Canadian dollar is one we would be foolish to ignore. If we keep pricing ourselves out of markets both at home and abroad, we shouldn't be surprised that we aren't selling or producing as much as we could, that we aren't generating adequate growth or enough job opportunities, and that we keep borrowing abroad rather than paying our way in the world.

How do we get out of this situation? There are still some people who would say that the answer is simple -- relax about inflation. Accept the proposition that a relatively high, continuing rate of inflation is the best we can hope for in existing circumstances. Expand government expenditure and the money supply rapidly again in order to restore strong economic growth and high employment in spite of the declining purchasing power of our money, and rely on our floating exchange rate to float downwards far enough and fast enough to enable us to compete internationally.

The trouble I have with policy advice of this sort is that it would compound our difficulties rather than resolve them. The more we followed advice of this sort the worse our problems would get. The rapid rate of monetary and fiscal expansion originally intended to stimulate production in Canada would instead generate strong expectations of higher inflation to come and would fuel a renewed acceleration of the wage-price spiral. The further and faster our exchange rate went down, the more our

domestic price level would be pushed up by higher import prices, and the more this would be translated into claims for correspondingly large wage increases. Whatever temporary improvement in our competitive position we had gained through exchange rate depreciation based on inflationary policies would soon be lost again as domestic inflation gathered momentum. It doesn't make sense to try to deal with the economic consequences of persisting inflation by inviting even more serious inflation.

This is not merely a theory. There are too many examples around the world of exactly this sequence of events. Unhappy and impatient as we are bound to be about the present state of our economy, we should be under no illusions about the danger that would lie in store for us in going down this particular path.

Well, if the persistence of inflationary expectations and behaviour is the basic reason why our economy isn't functioning very well these days, how can the problem be overcome? What can we do to improve our competitive position and restore the health of our economy? In principle, there are really only two ways out for our economy -- or for any other economy for that matter. One is through increased productivity. I include here the whole range of public economic policies and private initiatives that affect incentives and efficiency. The other is by keeping our costs under better control -- that is, the wages and salaries and other money incomes that the price of what we can produce

must cover. We can be competitive if we do what we can to be efficient, and at the same time avoid trying to extract money incomes from our production that are higher than the market will bear. Money incomes that are set too high mean over-priced goods and services and reduced employment opportunities. The high unemployment which inflationary practices generate is a self-inflicted wound.

Over the last year and a half we have made encouraging progress in Canada in gearing down the rate of increase of our labour costs and prices. We need to continue our efforts in this direction. I believe that the prices and incomes control programme has made a valuable contribution in this regard, and so have monetary and fiscal policies by avoiding the over-stimulation of demand. When the control period is over we will have to rely mainly on these traditional monetary and fiscal instruments. In other words, we shall have to fall back on the one means of price and wage restraint we have always had -- at least in the private sector -- namely, the maintenance of a market environment that will not readily support excessive increases in prices or rates of pay.

However, we need something more than that. We already have a decidedly weak market environment, and yet cost and price increases are still too large and too frequent. What we need and have not yet got is a sufficient degree of public confidence that inflation really is on the wane

and that it will not be permitted to revive again. What we also need is a more widespread recognition that when the price of labour or output is pushed up unduly, markets and jobs are endangered. This basic change in expectations and behaviour must somehow come about if inflation is to be dealt with effectively and if a sound basis for economic expansion is to be laid. The understanding and co-operation of all groups in the economy is required if we are to break out of the vicious circle that I mentioned earlier without even greater stresses and strains than we are now experiencing.

This brings me to the question of what can and is being done in the area of monetary policy to help restore satisfactory economic growth without inflation in Canada. The Bank of Canada is firmly committed to a policy of gradually lowering the rate of growth of the money supply over time. Under a policy of this kind, a reasonable rate of economic expansion can be accommodated so long as it is accompanied by some continuing decline in the rate of inflation. A gradual moderation of the rate of monetary expansion is necessary to help maintain a market environment in which large cost and price increases cannot be passed on easily or automatically. It is also necessary if people are to become convinced that their expectations of continuing rapid inflation are unfounded. Indeed, the Bank of Canada has made it very clear that no one should expect a resumption of rapid monetary expansion to accommodate any

future outbreak of large wage or price increases. While monetary policy can't provide the solution for all of our problems, no one should be in any doubt about one thing -- that inflation can never be controlled if the money supply is allowed to grow too rapidly.

It is true, of course, that the process of moving to much lower rates of monetary expansion and inflation than we have seen for some time involves many difficult and painful adjustments in economic behaviour, and that an attempt to make this happen too abruptly could be intolerably disruptive. That is why the approach the Bank is following is meant to be gradual and moderate rather than heavy-handed or extreme. It is against this background that last weekend's reduction in the Bank Rate must be seen if it is to be understood correctly.

More than a year and a half ago the Bank of Canada explicitly stated for the first time the monetary growth targets at which it was then aiming in its efforts to moderate the pace of monetary expansion. The objective at that time was to bring the growth rate of the money supply back down well below 15 per cent a year but not below 10 per cent a year. Over the ensuing months the Bank encountered considerable difficulty in keeping the rate of monetary expansion from exceeding the upper limit of the range at which it was aiming, and it was not until the spring of last year that clear evidence of slackening monetary growth appeared.

By last August, with the rate of inflation also coming down, the Bank felt able to lower its sights somewhat further, and a new target range for monetary growth of 8 to 12 per cent a year was announced. Since that time the Bank has had problems, not in keeping the growth of the money supply from exceeding the upper limit of this range, but in keeping it from falling below the 8 per cent a year lower limit. While the Bank is determined to avoid rates of monetary expansion too high to be consistent with a gradual decline in Canada's inflation rate, it wants at the same time to avoid unduly low rates of monetary growth. Our current economic situation and prospects clearly make it very desirable that interest rates be no higher than are necessary to avoid inflationary rates of increase in the money supply. That is why the Bank has again taken action to use the room now available for some further reduction in short-term interest rates in Canada.

I have tried in my remarks today to state as frankly as I can the nature of the problem this country faces as I see it and the direction in which I think we must move if we are to find a workable and enduring solution for our present difficulties. It is true that we still have a long way to go, but it is also true that we have come a long way back from the dangerous situation we were in only two years ago. There is much to be concerned about in our immediate situation -- the further increase in the unemployment rate, the renewed bulge in food prices, the uncertainty about the country's political future, and so on.

But there have also been some developments of an encouraging nature. As I mentioned earlier, the average size of wage and salary increases in Canada is continuing to moderate. The world economy is much less inflationary than it was a year or two ago, and after a lengthy pause last year, economic expansion has clearly resumed in most of the industrial countries, with growth prospects particularly good in the United States. The outlook for our exports has also been helped by the recent downward adjustment of the exchange rate of the Canadian dollar, an adjustment which was not brought about by the kind of inflationary policies that I referred to earlier. However, I would put at the top of the list the growing recognition in this country of the real nature of our national economic problem -- namely, that we Canadians cannot go on trying to pay ourselves more than we earn. Because this perception is increasingly reflected both in private and in public attitudes, I have high hopes that we are on the road back toward achieving the kind of economic performance that the Canadian economy is capable of realizing.

T FOR PUBLICATION BEFORE: 12:30 P.M. MOUNTAIN DAYLIGHT SAVING TIME
2:30 P.M. EASTERN DAYLIGHT SAVING TIME

SEPTEMBER 16, 1977

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE CALGARY CHAMBER OF COMMERCE
CALGARY, ALBERTA
SEPTEMBER 16, 1977

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to
The Calgary Chamber of Commerce
Calgary, Alberta
September 16, 1977

It is a pleasure to be in Calgary again and to have this opportunity of speaking to The Calgary Chamber of Commerce about our economic situation and the policy the Bank of Canada is following.

I am also glad to have the chance to learn something at first hand about the special concerns of people in this province. In the Bank of Canada we try to keep as closely in touch with economic developments in the various regions of the country as we can. In this effort we are assisted by our directors who come from right across the country. The Bank's Board is fortunate indeed to have among its members as able and well-informed a representative from Alberta as it has in the person of Mr. Robert Campbell. The Bank also has a branch, called an Agency, here in Calgary and last year we opened an office in Edmonton. The main role of our representative there is to help us keep more closely in touch with economic and financial developments in Alberta and the other prairie provinces.

One of the things a trip from Ottawa to Calgary does for anyone interested in economic matters is to remind him of how diverse

the Canadian economy really is. At a time when economic conditions in much of the rest of the country offer little to cheer about, this province strikes a visitor as an island of comparative prosperity. Of course I also know that there are questions and problems. These include the terms governing your out-of-province sales of oil and gas, the impact on Alberta of the northern gas pipeline project, the market situation for beef and grain, the development within the province of secondary industry, and the future of the important petro-chemical industry. I know that many thoughtful Albertans are deeply concerned about what the vigorous activity in the energy field is doing to the cost structure and competitive position of other forms of economic activity in this province, and how this is likely to affect Alberta's future prospects. Keeping costs under control is certainly one major problem that Alberta shares with the rest of the country, and you are therefore bound to have an interest in the general problem facing Canadians of how to bring about the progressive reduction in our rate of inflation that is required if we are to achieve sustained economic prosperity.

One hears a lot of unhappiness expressed these days about the state of the Canadian economy -- and for obvious reasons. We have high levels of unemployment, we have unused productive capacity and we have a rate of inflation which, though down from peak levels, is still much too high. Today I would like to offer some comments on the nature of the underlying problem we face and the challenge that confronts us in trying to make our economy work better in the years ahead.

The situation in which we find ourselves today is the product of our economic history over recent years. Let me refer briefly to that history.

In common with almost every other industrial country, Canada emerged from the worldwide inflationary boom of 1973 with wages and prices escalating at unprecedented double-digit rates. In some respects Canada had been exceptionally lucky. Unlike many other industrial countries during the boom, Canada had been an important beneficiary of the dramatic inflation of world demand and prices for farm commodities and industrial materials, because these are products we produce and export on a large scale. Since Canada was in a net surplus position in its external trade in petroleum and natural gas, the four-fold increase in the international price of oil did not have nearly as great a disruptive impact here as in many other countries.

At the time, Canada's good fortune in these respects helped make it possible for Canadians to experience unusually rapid rates of increase in both private and public consumption and investment. It also delayed the arrival in Canada of the subsequent business recession, and it greatly reduced the severity of that recession by comparison with what happened in the United States and many overseas countries.

These very same factors, however, also added to the problem of dealing with inflation, and by the summer of 1975 some unwelcome consequences of our relative prosperity were becoming alarmingly apparent. The hectic process of leap-frogging wage and price increases was still gathering momentum in Canada, while in the United States -- our major trading partner -- inflation was already on the wane as that country began to recover from its plunge into deep recession. We were facing the social and economic strains of rampant inflation at home and our ability to compete internationally was being rapidly undermined.

The experience of many countries in recent years shows both how easy it is to let inflation get out of hand and how difficult and painful it is to get it back under control. A major reason for this is that in the contemporary world a severe attack of inflation leaves as its legacy a widespread and stubbornly-held expectation that rapid inflation will continue indefinitely. Because of this expectation prices and costs continue to be pushed higher and higher even when the economy is well into a prolonged period of soft markets for goods and services and labour. So long as people persist in basing their economic behaviour on expectations of continuing rapid inflation in the face of policies designed to bring inflation under control, the performance of the economy is bound to be highly unsatisfactory.

Strong expectations of continuing inflation are a comparatively recent phenomenon. They developed rather slowly over a long period. Many of you will remember that, after the tragic experience of the 'thirties, the psychology of depression remained with us for a long time. Despite the severe shortages of the immediate post-war period and the massive increases in money and liquidity produced by war finance, and indeed despite the sharp upward adjustment in the price level that followed immediately after the war, expectations of continuing inflation did not develop to any important extent. Nor did they after the sharp outburst of inflation at the time of the Korean war. The widespread fear of an eventual return to depression seemed to exercise a strong restraining influence on attitudes towards prices and costs for many years into the post-war period, even at times of intense demand pressure on our resources. Inflation on any significant scale seemed to be regarded as a phenomenon associated only with war and its immediate aftermath, and there was indeed a strong historical basis for that view.

But attitudes began to change as during the 1950's and the 1960's strong economic growth continued with only short interruptions and as moderate inflation gave way to more rapid inflation. It was becoming increasingly apparent that the well-intentioned desire tc terminate periods of recession and high unemployment as soon as possible was leading each time to fiscal and monetary policies that involved the risk of accelerating inflation. When the expansionary fiscal and monetary

policies adopted throughout the industrial world to combat the recession of the early 'seventies -- together with a number of other special factors -- produced double-digit inflation, expectations of continually rising prices were greatly intensified, and they now constitute a major impediment to good economic performance. We have reached the stage where expectations of inflation dominate the scene much as expectations of depression did at the end of the war. Now considerable caution must be exercised in introducing expansionary measures to stimulate output and employment for fear that such action will give fresh impetus to inflationary expectations and behaviour. Public policies must provide a firm basis for confidence in the future value of money. It is now "game over" with respect to any attempt to solve our problems by policies that take major risks on the side of inflation.

Expectations of a related kind that grew out of the post-war experience of rapidly rising living standards are also causing some difficulty. The view seems to have developed that real income per person employed, i.e., money income after adjustment for inflation, should automatically grow every year whether or not improvements in productivity make this possible. To attempt to satisfy these unrealistic expectations is a sure recipe for inflation. One does not have to look far to see that all countries go through periods when real output per person does decline; economic advance is not an uninterrupted process and it is not entirely within the control of any country. We cannot afford to act as though the

world owes us a living and a steadily improving one at that. How well we get along in today's strong competitive world depends on our willingness and ability to work with increasing efficiency, and on our willingness to accept the fact that we cannot expect to enjoy high levels of employment if we insist on charging more for our goods and services than the market is prepared to pay.

As I see it, the persistence of inflationary attitudes and behaviour is a serious obstacle that we face in getting our economy back in a position in which it can function satisfactorily. It is a major factor responsible for the curious combination of high inflation and high unemployment that we are currently experiencing. It is also the main reason why inflation and unemployment are no longer separate problems between which priorities can shift, but are rather a single, interrelated problem.

The conclusion, which I believe to be inescapable, is that if we want to achieve and sustain high levels of output and high employment we really have no alternative but to grapple with inflation and with the inflationary practices that keep it going.

That of course is what we have been trying to do in Canada for some time through a combination of fiscal and monetary restraint supplemented by the Anti-Inflation Board programme. The AIB has attacked the problem of inflationary expectations directly and I believe

this has been helpful. What can be said about the performance of the economy given these policies and the other influences at work?

To begin with, what degree of progress are we making in getting our inflation under control? The short answer I would give is that we are indeed making significant progress, not as rapidly as we might have hoped, but nevertheless solid progress.

I realize that things may not look quite this way judged solely by the recent behaviour of the over-all Index of Consumer Prices. By last December the twelve-month increase in this Index had fallen dramatically from around 11 per cent in the summer of 1975 to less than 6 per cent. Subsequently, however, the twelve-month increase in the Index has moved back up to over 8 per cent. Taken at face value this looks like evidence of back-sliding, but appearances can be deceiving. The degree of improvement in Canada's underlying cost and price performance last year was not in fact nearly so rapid as might be inferred from the behaviour of the Consumer Price Index. The latter was heavily influenced by an unusual and obviously temporary decline in the absolute level of food prices, together with an appreciation of the Canadian dollar that just as obviously was unlikely to last very long. By the same token, the gradual but continuing improvement in our underlying cost and price situation so far this year has been obscured by the influence of a renewed jump in food prices -- which already

seems to have tapered off -- and by the immediate price impact of the substantial exchange rate depreciation we have experienced.

The impression of a gradual but continuing improvement in Canada's underlying cost and price situation is supported by an examination of wage settlement data. Average annual increases in base wage rates over the life of contracts, which were running at 17 per cent a year in 1975, came down to 10 per cent in 1976 and down further to just under 8 per cent in the second quarter of this year. Both in terms of most of the more readily comparable price measures and in terms of wage-settlement data, it now seems fair to say that Canada's underlying inflation rate, though still too high, is currently running no more than about one percentage point a year above the rate of inflation in the United States.

I realize that to many Canadians the progress we are making against inflation seems disappointingly slow. Certainly there are no grounds for complacency: we still have to get through the process of de-control when it comes without throwing away the opportunity that the recent exchange rate adjustment has given us to repair the damage to our international competitive position and restore a more viable structure of international trade and capital flows. The rates of increase of our money incomes and prices have to decelerate for a considerable period yet -- with or without controls. We are by no means out of the woods yet. But if we can manage

to persevere, our prospects on the inflation front are by no means devoid of hope.

So much for our recent cost and price performance. What, then, about the recent hesitant growth of the Canadian economy, the increase in the number of unemployed, the unfavourable climate for business investment and the persistence of such a large current account deficit in our international balance of payments and the related continuing rapid growth of our indebtedness to foreigners? In these respects the recent performance of our economy is generally regarded as being highly unsatisfactory -- and so it is. But I do not agree with some extreme statements about how unsatisfactory it is. One occasionally even hears it suggested that we may be headed for something comparable to the collapse of the 1930's. Well, we certainly face real problems in trying to cure our unemployment situation, but they are far from those of the 1930's.

For one thing, we are currently living in an international environment that is generally favourable to economic growth in Canada. The level of world economic activity may not be as high as one might wish, but it is nevertheless relatively high. It may not be growing as rapidly as one might wish -- especially in overseas countries -- but it is certainly growing. This means that so long as we are competitive we have a good chance of achieving an export-led expansion.

Within Canada the flow of money expenditure, though not as buoyant as it might be if inflation had not generated so much uncertainty, seems likely to rise fairly strongly in the year ahead. Of course if much of the rising flow of spending continues to be absorbed by rising prices here at home, or satisfied by foreign competition, its positive impact on the physical volume of Canadian output, and in turn on employment and new investment, will be that much weaker. In a very real sense, then, the prospects for employment and output in Canada depend very much on the response of wages and prices to the present economic climate. If that response is good our economic situation can improve steadily. In such circumstances our economic policies, however they may be adjusted from time to time, must be consistent with the maintenance of an environment in which a non-inflationary response is encouraged.

Now against this background I would like to turn more specifically to monetary policy. The basic objective of the monetary policy we are following is to encourage a moderating trend in our inflation rate so that we can achieve the healthy economic growth we all want.

One doesn't need to be an economist to grasp the idea that whatever the nature of the forces immediately responsible for driving up the general level of wages and prices, there is no way in which the

process can continue indefinitely unless the amount of money in the economy is allowed to keep rising fast enough to accommodate it. This suggests a prescription for bringing inflation to an end; stop the money supply from increasing at rates faster than the minimum rate needed to accommodate satisfactory economic growth at stable prices.

This is, in fact, the ultimate goal of the strategy currently being pursued by the Bank of Canada. There would, however, be serious repercussions if the rate of monetary expansion were cut back very rapidly.

The most difficult obstacle is one to which I have already referred at some length in this speech, namely, the extent to which inflationary expectations and behaviour have become firmly established. In the present circumstances a sharp reduction in the rate of monetary expansion would, in the short run, have a severely restrictive impact on the volume of output and employment in Canada. While the hard truth of the matter is that any effective action to lower the rate of inflation seems bound to involve at least some temporary reduction in the growth of output and jobs, no one wants to invite hardship that can be avoided. That is why the Bank of Canada is following a long-term policy of moving towards a non-inflationary rate of monetary expansion by stages, lowering its monetary growth targets in a series

of gradual steps spread out over a period of years rather than all at once. We believe that in this way the responses of the economy can and will be more orderly, the hardship will be minimized and the benefits will be more lasting.

Two years ago the Bank of Canada initiated the practice of making public from time to time the monetary growth targets towards which it was currently working. At that time the announced objective was to keep the trend rate of increase of the money supply, defined as currency and chartered bank demand deposits, well below 15 per cent a year, but not lower than 10 per cent. By the early spring of 1976 the actual growth of the money supply over the previous ten months had been held to about 11 1/2 per cent, and this was taken as the new base period when, in August of 1976, the upper and lower limits of the target range were revised downward to 12 and 8 per cent a year, respectively. During much of the subsequent period the problem for the Bank of Canada has not been that of trying to resist a tendency for the rate of monetary expansion to become too high; rather, the sluggishness of the economy has required four successive reductions in the Bank Rate in order to counter a persistent tendency for the growth of the money supply to fall short of the lower limit of the target range.

In recent months the impact of these interest rate reductions has brought the trend rate of increase of the money supply back up to around a 9 per cent annual rate. Given our present economic situation, I am reasonably satisfied with the recent trend of the money supply, and I have not regarded it as a matter of any great urgency to undertake a further revision of the upper and lower limits of our target range for monetary growth, although we will be doing so in due course.

An up-dating of the Bank's monetary growth targets does not of itself signal or involve any change in existing credit conditions. Action along these lines does, however, recognize the fact that the scale on which inflation is being financed through monetary expansion should continue to decline with the passage of time if inflation itself is to continue to slacken. The setting of new targets must also, of course, take into account the current state of the economy and the need for enough monetary expansion to support a reasonable rate of economic growth as inflation recedes.

The main point I want to register, however, is that the Bank of Canada is as determined as ever to maintain firm control over the rate of monetary expansion as we move into the critical period ahead. But I must add that while it is essential to have good monetary and other economic policies it has become increasingly clear that the way people respond to these policies and to the general economic

environment is equally important. The responsibility for solving Canada's economic difficulties cannot be left entirely to public policies. To get back to attitudes and behaviour compatible with high and sustainable levels of output and employment is thus a major challenge to all Canadians.

NOT FOR PUBLICATION BEFORE: 1:00 P.M. EASTERN STANDARD TIME
NOVEMBER 28, 1977

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE CANADIAN CLUB OF TORONTO
TORONTO, ONTARIO
NOVEMBER 28TH, 1977

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to
The Canadian Club of Toronto
November 28, 1977

For some time now I have sought on occasions like this one to explain what I believe to be the main obstacles to good economic performance in Canada and the role that monetary policy can play in helping to overcome them. What I have been trying to emphasize is the difficulty of achieving more satisfactory levels of output and employment so long as rates of pay and prices in Canada keep being pushed upwards as rapidly as they have been in recent years. We need to ensure, of course, that the aggregate level of public and private spending by Canadians grows at a reasonable rate. But we also need to keep the prices of our goods and services -- and the cost of the labour needed to produce them -- from rising faster than our markets both at home and abroad will bear. That's why I believe that we can deal successfully with our unemployment problem only if at the same time we manage to deal successfully with our inflation problem -- only, that is, if we become more competitive.

It's on these grounds that I have been arguing the case for monetary and other policies, together with changes in private attitudes

and behaviour, that will gear down the rate of inflation and contribute to a lasting improvement in our unemployment situation. It goes without saying that the necessary changes in the way we have been conducting our affairs in Canada cannot be made easily or quickly. The expectations and habits acquired over a long period of gradually escalating inflation are now too deeply ingrained in our society, and an attempt to break them overnight would be intolerably disruptive. That's why the shift of emphasis in public policy in Canada in recent years has been designed to gear down the pace of inflation by gradual stages over a period of years. Thus the monetary policy that we are following involves a gradual but continuing moderation of the rate of monetary growth -- not a sudden turning off of the tap, but rather a continuing firm resistance to underwriting future increases in rates of pay and prices as large as those of the recent past. In my view this is a reasonable way of attacking the problem. But if it is to pay off in the end, it will take both patience and determination.

I have attached crucial importance to the role that inflationary expectations play in the process that keeps our costs and prices rising rapidly even when the market environment is too weak to support such increases. Expectations of inflation arise from past performance. To change these expectations we must leave no doubt that there is the will to deal with inflation. That is why there can be no turning back half way down the road.

Briefly, that's the basic message of my recent speeches and annual reports. Today I want to say a few words about what has been

achieved so far in getting the Canadian economy back on track, and how this may influence its performance over the period ahead.

So far as the current economic situation is concerned, there is no shortage of difficulties to point to. Unemployment remains undesirably high. In recent months food prices have produced a significant bulge in the rate of increase in consumer prices. Although there has recently been some recovery in retail sales, consumer confidence does not seem to be strong. Business confidence is also at a rather low ebb, judging from the level of new investment in plant and equipment in fields other than energy. On the external side, we have been making progress in our merchandise trade but our balance of payments deficit on current account remains very large and we are financing it by going into debt abroad at a rate that is correspondingly high.

That's one side of the current picture, but there is another side. There are factors at work in our economy which, given time, should considerably improve our situation. Indeed, I would argue that the Canadian economy has now in fact made many of the adjustments that were necessary in order to allow it to perform better and to compete more effectively with the rest of the world. Thus, while the bad news is that our economy has been going through a difficult period, the good news is that we may already have completed a large part of what was bound to be a difficult journey. Much of the essential groundwork has already been laid both for a pick-up

in the pace of economic activity and for a better cost and price performance -- provided, that is, that we stick to the course we are on.

The most fundamental way in which we have been getting our economy into better shape is through the progress that has been made in reducing inflation. On that front we have seen a remarkable moderation of the average size of negotiated wage settlements -- from annual increases that were running in the 15 to 20 per cent range back in 1975 to increases that are currently averaging no more than 7 to 8 per cent a year, and that soon, now that the new guideline is in effect, should be down to 6 per cent or less. Thus the rate of increase in our labour costs -- a fundamental determinant of our ability to compete internationally -- is now back into much the same range as that of labour cost increases abroad.

At first glance the recent trend of the Consumer Price Index would seem to be at odds with the view that the underlying pace of inflation in Canada is continuing to moderate. But here is an instance where appearances are deceiving. An unusual temporary down-swing in food prices in 1976, combined with the effects of a strong Canadian dollar in holding down the prices of imported consumer goods, gave an exaggerated impression of the degree to which our underlying price performance was improving at that time. A renewed bulge in food prices in 1977, combined with the effects of a substantial decline in our exchange rate, have

correspondingly obscured the continuing improvement in our non-food price performance over the course of the present year. Taking the two years together, the over-all rise in the Consumer Price Index to date has not been greatly out of line with what had been hoped for back in 1975 when the Anti-Inflation Program was first introduced. Hopefully, the prices of foodstuffs both from domestic and foreign sources will not continue to rise at such high rates much longer. Meanwhile, the recent weakness of world prices for many industrial commodities, together with the decline in Canadian interest rates from last year's levels, both represent -- for the time being at least -- some relief from pressure in these particular areas of production costs.

Other important adjustments that have been made in the economy include a firmer control of expenditures by governments across the country and a less rapid rate of monetary expansion. This relatively moderate rate of monetary growth has been accompanied by a decline in short-term interest rates, which are now significantly lower than a year ago. The same is true of mortgage rates. Long-term rates have also declined. Interest rates are not high now in relation to the underlying rate of inflation. Funds are readily available to creditworthy borrowers in financial markets and from financial institutions. Whether looked at in relation to our monetary targets or in relation to credit conditions, the current setting of monetary policy is not, in my view, impeding the achievement of more satisfactory levels of output and employment in Canada.

Another important adjustment that has occurred is the large decline in the foreign exchange value of the Canadian dollar over the past twelve months. In large measure a decline of this kind was inevitable sooner or later because of the recognition in exchange markets that costs and prices inside Canada had gotten far out of line with those of our chief trading partners, particularly the United States. It is our past catching up with us. The constructive aspect of this exchange rate adjustment is the offset it provides to the damage done in recent years to our international competitive position. The help it gives us will not last very long, however, if Canadians insist on obtaining compensating increases in rates of pay to offset the direct effect of exchange depreciation on Canadian prices. To take advantage of the degree to which it has restored our competitive position, we must strictly contain the feed-back effects of this exchange rate depreciation on our domestic costs of production. If we fail to do so we shall be only running in circles and getting nowhere -- at least nowhere that we want to go.

The combination of an improving domestic cost and price performance and a substantial depreciation of the Canadian dollar has gone a long way towards building a solid basis for a resumption of more satisfactory rates of growth of output and employment in Canada. I am in fact hopeful that we will see the beginning of this better performance in the course of the coming year.

For this hope to be realized various things must go right. One of them is that the economic expansion that is currently proceeding in the outside world must continue. In the view of some observers, the fact that this expansion lacks the exuberance of previous periods of world economic recovery gives reason to fear that it may soon peter out, abetted by a rising tide of protectionism, unless governments adopt considerably more aggressive stimulatory policies than they are now doing. I concede that there are risks here. There are many countries in the world experiencing economic conditions that are unsatisfactory for essentially the same reasons that they are unsatisfactory here in Canada. Investment in new plant and equipment is relatively weak throughout the industrial world. But the prospects for a continued reasonably strong expansion of the U.S. economy, which is so important for us, look good. Other major economies are likely to grow too, though perhaps at a modest rate. The reluctance of major countries to court the risk of a renewal of inflation may in fact turn out to augur well for a moderately-paced but long-lived expansion of the world economy.

Another thing that must go right is a strengthening of business and consumer confidence in Canada. Confidence is usually at its lowest ebb just before economic activity finally begins to pick up, but it strengthens quickly with an upturn in activity. It is not unreasonable to expect signs of such a revival to make their appearance before long given the prospects for somewhat stronger growth in total spending and

the improvement that has occurred in our competitive position. A demonstration that Canadians are capable of getting their domestic inflation problem back under firm control will certainly help in restoring confidence. Economic factors are, however, not the only considerations and much will also depend on the course of events in the on-going debate over the political future of Quebec and the rest of Canada.

Perhaps the major requirement on the domestic scene concerns the wage and price setting behaviour of Canadians in the period ahead. For the remainder of the control programme, the basic guideline for pay increases has been held down to 6 per cent, and profit margin controls will remain in effect for most firms throughout 1978. These arrangements should be of considerable help in limiting the price and cost impact of the decline in our exchange rate. But what will happen as controls come to an end? What will be left to keep cost increases from greatly outstripping productivity gains, and prices from rising at least proportionately? In the private sector of the economy the answer is: what there always was -- the discipline of competitive market conditions and the bottom line. As we approach the decontrol period it is important that there be a widespread appreciation that this form of restraint on price and cost increases will be there, and that even though markets may be strengthening next year, they will not be strong enough to bear average increases in rates of pay of more than 6 per cent a year. In this

environment, inflationary pay increases -- whether a post-control bubble or not -- will cost Canadians jobs.

The responsibility for adjusting our wage and price behaviour to a market environment which, while reasonably strong, will not be inflationary, is one that all of us share. I realize how distasteful it is for any group in the country, whether private or public, to accept the fact that increases in its own rates of pay or prices or taxes or other impositions can be a significant factor in pushing up our costs of production to levels that make it more difficult for some Canadians to find work. But the hard fact is that these myriad decisions, taken together, can have this effect, and that's why I hope that in the period that lies ahead such decisions will be made in a realistic and responsible way. And of course I do not in any way exempt the public sector from such responsibility. There, for example, if pay demands are made that would outstrip the gains achieved in private employment, much will depend on the determination of governments and their agencies not to yield to them. The cost of giving in to such demands must inevitably be borne by the public either as taxpayers or as captive consumers of public services, and the example of excessive pay increases in the public sector would undoubtedly lead to at least some excessive increases in the private sector.

Naturally I am anxious that as we approach the end of controls no one should look to monetary policy to accommodate inflationary increases

in costs and prices through excessive monetary expansion. There are two main ways a central bank can contribute to inflation. One is to overdo monetary expansion by sacrificing longer-run considerations in the desire to help bring about a quick improvement in economic activity. The other is to overdo monetary expansion by accommodating passively whatever rates of inflation are generated by excessive pay and price increases. Neither does any good in the long run. We have been around that track before. This, in part, was what the Bank's recent announcement of a reduction in its monetary growth targets was about. It was necessarily rather technical in character but I think its message was reasonably clear. It is, first, an assurance that the Bank will permit enough monetary expansion to accommodate as much real growth in the economy as could reasonably be expected over the next year or so, provided this is accompanied by some decline in the current rate of inflation. Secondly, as I have already indicated, it was intended to underline the fact that the Bank is not prepared to permit any greater monetary expansion than this objective requires.

It is clear that we Canadians are going to discover the answers to some critical questions in the next year or so. We are going to find out, for example, whether we can make our relatively free market system of price and income determination work again. There are the other risks and uncertainties that I have mentioned, and more. Small wonder that there is a range of views about the likely performance of the Canadian

economy in 1978. My own view, based largely on the degree to which the economy has already adjusted to the necessities of the situation, is that there are reasonable grounds for feeling a degree of optimism about this country's economic prospects. It is not unreasonable to suppose that we Canadians, if we act sensibly, can reduce our rate of inflation next year to roughly the same, or even a little lower rate, than that of the United States. It is also not unreasonable to suppose that we can at the same time achieve a quite respectable increase in employment and in the physical volume of production in Canada. As I have indicated, the monetary growth targets that the Bank of Canada is currently pursuing, though lower than last year's targets, are intentionally designed to accommodate an outcome of this general character without significant strain on credit market conditions.

Whether or not things work out as well as this in the Canadian economy in 1978 will depend in large measure on the response of Canadians in their wage and price behaviour to the current setting of public policies.

There is no doubt that we can, if we are so inclined, revert to saddling our economy with costs of production so high as to perpetuate existing unemployment levels, further erode the value of our money, and throw away the chances of achieving the degree of prosperity that a country as potentially rich as Canada ought to be able to afford its citizens.

I believe that Canadians have too much common sense and too much sense of community responsibility to respond to the challenge of

the times in that way. I believe that we have all learned some painful lessons from our recent economic history, and that we are indeed making progress in overcoming our economic problems. One hears a good deal of pessimistic comment these days but I suggest that, as is often the case in economic matters, much of it is well out of date. Such pessimism would have been more appropriate a few years ago when we were really headed for trouble -- for example, during the period when money incomes in Canada were increasing by as much as 15 to 20 per cent a year while increases just across the border were far smaller. How did we imagine that was going to work out?

For the reasons I have given today, I believe we have come a long way back from a very dangerous situation and that we are still moving in the right direction. That's why today I count myself among the optimists about Canada's future economic prospects.

Remarks by G.E. Freeman, Deputy Governor, Bank of Canada,
at the Economic Outlook Conference of the
Canadian Association for Business Economics,
Ottawa, May 11, 1978

I take it that what I have to say about monetary policy this afternoon is supposed to have some bearing on the general topic for this session, which is described as "Future Economic Policy Options: Likely Scenarios". So far as monetary policy is concerned, I propose to lead up to this question in a rather roundabout way rather than attack it directly. In particular, I want to sketch in a little of the background of current monetary policy by way of preamble. The main reason I want to do this is because I think there is something to be learned from the experience of recent years about how the problem of policy choice is likely to present itself in practice in the years that lie ahead.

The origins of the basic policy approach which the Bank of Canada has now been following for some time go back to the critical inflationary situation in which this country found itself earlier in the 1970's. As you know, during the course of 1973 Canada along with most other countries was quite suddenly and unexpectedly caught up in an intense inflationary boom of world-wide dimensions.

For more than two years prior to this massive upsurge in world demand and prices, the most immediate concern of fiscal and monetary policy in

Canada had been to hasten the process of economic recovery from a cyclical downturn in activity that had occurred in 1969-70. Although the Bank of Canada had viewed with considerable misgiving the stepped-up rate of monetary expansion that was a by-product of its policy approach during this period, its operating posture at the time was strongly influenced by a desire to avoid any substantial upward movement of nominal interest rates or of the external value of the Canadian dollar so long as the economy still appeared to be operating well below normal capacity levels. Plausible evidence for this belief was a rate of unemployment which, in part for special reasons not adequately recognized at the time, continued throughout 1971 and 1972 to run at abnormally high levels by comparison with previous Canadian experience.

Thus the impact on Canada of the unexpected shortfall in world supplies of agricultural commodities that emerged towards the end of 1972, together with the soaring demand for industrial commodities generated by the world-wide boom of 1973, was super-imposed on a domestic demand situation that was already turning quite strong. Because Canada is such a major producer of these foodstuffs and industrial materials, the steep rise in world demand for (and world prices of) these commodities greatly stimulated Canadian levels of income and economic activity, while at the same time markedly improving Canada's international terms of trade and directly pushing up its internal price level.

The equally unexpected world oil price shock at the end of 1973 that subsequently had such a marked deflationary impact on levels of demand and economic activity in most of the other industrial countries did not have nearly as strong a direct impact on Canada, whose exports of petroleum products were then roughly equal to its imports of these commodities. The result was that in 1974 the developing world-wide recession came later, and was much milder in Canada than in many other countries, notably the United States. However, the price that Canada was to pay for its relative immunity from deep recession in 1974 became plain in 1975 as economic growth resumed. By that time Canada was experiencing a wage explosion of alarming proportions -- and thus the prospect of continuing double-digit inflation for some time to come -- whereas in the United States, its major trading partner, price inflation was already abating rapidly and wage trends continued to be remarkably stable. The fact that demand and economic activity did not fall off nearly as sharply in Canada during 1974-75 as in the United States and Europe was also a major factor in the emergence at this time of a very large current account deficit in Canada's international balance of payments.

In essence, then, by mid-1975 Canada found itself unexpectedly saddled with a substantially higher continuing rate of domestic inflation than that of its major trading partner and with growing concern on the part of Canadians about the future course of the country's price level, international competitive position and exchange rate.

To what extent the problems that confronted the country in 1975 might have been less intractable if they had been fully anticipated and responded to by timely policy adjustments in earlier years is an interesting hypothetical question, but not one that is germane to the main thrust of what I want to say today. The hard fact is that economic policy has to be made in the world as we find it, not in the world as we supposed it might be or would have preferred it to be. And in the circumstances of 1975, uncomfortably few options deserving of serious consideration were open to monetary policy, none of them very attractive.

An attempt to put off the day of reckoning as long as possible by permitting monetary expansion to continue at whatever rate was needed to fully accommodate the inflationary process looked like a sure recipe for disaster. On the other hand, too sharp or drastic a curtailment of the rate of monetary expansion in the hope of reducing inflation quickly would almost certainly have pushed the Canadian economy into sharper recession, and soon risked alienating support for the continuation of any meaningful degree of monetary restraint. The remaining alternative was to progressively gear down the rate of monetary expansion in a series of gradual steps over a period of years. Such a policy approach had the disadvantage that it could promise neither rapid progress in overcoming inflation nor fully satisfactory levels of economic activity for some time to come. Thus it involved the risk that

Canadians would lose patience with it before it had achieved its goals. But given the alternatives this middle course seemed the best choice available, and it is the one that the Bank of Canada has now been pursuing for almost three years.

The implementation of this policy to date has involved the announcement from time to time of progressively lower target ranges for the growth rate of the money supply, narrowly defined as currency and demand deposits or M1. In setting these targets, the Bank is in effect placing an upper limit on the growth rate of money expenditure in the economy that it would, in the normal course of events, be prepared to accommodate for the time being without permitting short-term interest rates to rise. At the same time it sets a lower limit below which a decline in short-term interest rates would normally be called for if the growth rate of money expenditure in the economy should turn unduly weak.

The recent Annual Report of the Governor of the Bank of Canada is in effect a progress report on how the Canadian economy has been responding to the monetary and other economic policies that have been invoked in recent years in order to wind down our domestic inflation, restore our ability to compete internationally, and thus permit a return to more satisfactory levels of economic activity.

Its main theme is that, despite various recent setbacks, we have indeed made solid progress in effecting the difficult transition that is required if there is to be a lasting improvement in our economic prospects. The rate of increase in our labour costs is now back down into essentially the same range as that of the United States. Since our ability to compete with the outside world had been severely damaged by several years of rapid domestic inflation, it was inevitable that at some stage the exchange rate consequences of our past history would catch up with us. The substantial exchange rate adjustment that has now occurred holds out the prospect of a greatly improved competitive position. This prospect will rapidly fade away, of course, if the immediate impact of the exchange rate adjustment on the price level in Canada is simply translated into corresponding increases in money incomes -- and hence in our costs of production. Up to the time the Report was written, the exchange rate adjustment was judged to have gone reasonably well. For the future, the best way to avoid problems related to the external value of the Canadian dollar was to ensure that its internal value would be maintained. There has been a welcome change of attitudes on the part of governments as well as Canadians generally with regard both to the scale of public expenditure and to the unintended side-effects of various governmental initiatives. At the same time the Bank of Canada has received encouraging support in its efforts to conduct monetary policy in terms of a gradual moderation of the pace of monetary expansion within the framework of a medium-term time perspective.

The Report goes on to acknowledge a number of major disappointments encountered during the course of 1977 -- in particular, the further upward drift of the unemployment rate and the renewed upsurge of food prices. It also emphasizes the extent of the challenge facing Canadians over the period immediately ahead if the country is to consolidate the progress made to date in resolving its inflation problems. The mandatory income guidelines administered by the Anti-Inflation Board are now in the process of being phased out, wage-and-price-setting decisions are still vulnerable to a resurgence of inflationary expectations, and the questions that have been raised about the place of Quebec in the Canadian federation remain unresolved. But the Governor expresses confidence that we have been moving in the right direction and that our prospects are good if we do not lose heart.

To bring the story fully up to date, I might say a word or two about the response of monetary policy to the recent course of events in the foreign exchange market. As you know, further strong downward pressure on the Canadian dollar began to develop early this year against a background of persistent weakness of the U.S. dollar on world currency markets, and this downward pressure was a recurrent phenomenon in the Canadian exchange market until our dollar rallied in the latter part of April.

Underlying this situation was the fact that in recent months the net inflow of capital into Canada, particularly that part of the inflow arising from the foreign borrowing of provinces, municipalities and corporations, has been

unusually low relative to the size of Canada's deficit on current account transactions. This deficit is still substantial, even though it seems likely to be smaller this year than last as Canada is now generating a large and growing surplus in its merchandise trade. Moreover, for seasonal reasons the bulk of the deficit is concentrated in the early part of the year.

Thus as the Canadian dollar began to exhibit renewed weakness early in 1978 in response to this combination of events, growing concern arising out of the exchange rate movement itself soon began to reinforce the downward pressure through a resumption of the speculative short-term capital outflows that have been a recurrent phenomenon of recent years. Although a floating exchange rate system has many advantages and is indeed the only practicable system in today's world, it is asking a lot of the exchange market to move the rate a very considerable distance without incurring the risk that it may overshoot because of a developing problem of confidence. Given the magnitude of the exchange rate adjustment that Canada had already experienced over the preceding fifteen months, the prospect of a further substantial decline in the rate at this time was most unwelcome. Too large an exchange rate adjustment over too short a period of time would not be helpful in restoring Canada's international competitive position on a durable basis. The larger the depreciation, the larger its direct short-run impact on the price level in Canada, and the greater the risk that this would soon lead to large compensating

increases in money incomes. The end result would be to give domestic inflation and inflationary expectations a renewed lease on life and thus to invite the risk of even further exchange depreciation.

In the circumstances it was clear that Canada was far from having a balance of payments problem that required drastic measures of the kind traditionally invoked where the problem arises from excessive demand pressures overloading the domestic economy. Nor were heroic steps required to defend an exchange rate fixed at some particular level. Nevertheless, in order to maintain reasonable confidence in the exchange value of the dollar while at the same time being as protective of domestic economic activity as possible, it seemed essential to provide assurance that there would be an adequate continuing inflow of capital into Canada, since our current account deficit clearly cannot be eliminated over night. One way of achieving this objective was for the Government of Canada to take on, to the extent necessary, part of the job of raising capital abroad, and to make clear that it was able to do so. Another was for the Bank of Canada to act to move short-term interest rates somewhat higher relative to rates abroad.

Since late 1976 there had been a substantial reduction in the level of short-term interest rates in Canada and a substantial increase in the level of such rates in the United States, the effect of which had been to eliminate any substantial difference between these rates in the two countries. Early in March

and again early in April, the Bank of Canada took action, signalled by two successive Bank Rate increases, to raise the level of short-term interest rates in Canada by a total of roughly one percentage point. This had the effect of increasing correspondingly the interest return foregone by firms and individuals who were keeping funds invested temporarily in U.S. dollars in anticipation of a further decline in the external value of the Canadian dollar.

At the same time the Government took action to help finance the current account deficit by itself borrowing substantial amounts abroad in order to supplement the net capital inflow through other channels. The proceeds of these borrowings have enabled the Government to more than replenish the exchange reserves it has sold in the foreign exchange market in the course of recent months, and large stand-by credit facilities have been arranged to ensure that the Government will at all times be in a position to provide further supplemental financing if and as required. So long as Canada continues to run a substantial current account deficit, the financing of this deficit will continue to require a substantial net inflow of capital, and for the borrowers as for the country as a whole, these additional borrowings are bound to have an interest cost attached to them. To the extent that the necessary borrowing is done by the Government of Canada rather than by junior governments or corporations which cannot borrow on as favourable terms, this interest cost will of course be less than it would be otherwise.

No doubt these various recent initiatives have introduced elements of novelty both into the way in which monetary policy is being conducted in Canada and into the kind of exchange rate regime Canada is trying to maintain. I doubt very much, however, whether these initiatives will be seen a year from now as representing in any sense fundamental or long-lasting departures from the general course of recent economic policy.

It is true that neither the present state of the domestic economy nor the recent pace of monetary expansion would, in the normal course of events, have seemed to call for any marked upward adjustment of short-term interest rates in Canada -- however temporary -- at this time. Indeed, from mid-March through April our money supply readings have once again dipped somewhat below the lower limit of the Bank's present target range, as they did temporarily in the corresponding weeks of 1976 and 1977 for special reasons as yet only partly understood. (The current dip is not, to any important extent, the result of the rise in interest rates, which is still too recent to have had much effect on money supply growth.) Even the trend of the broader monetary aggregates, whose rapid growth a year ago attracted considerable public comment, has since slackened markedly. Nevertheless, in responding albeit reluctantly to the immediate problem of maintaining confidence in the exchange market, the Bank of Canada certainly did not feel that it was abandoning the pursuit of its near-term monetary growth targets announced

last autumn, let alone abandoning the whole medium-term policy approach it has been following for almost three years. The Bank's confidence that monetary policy will not be driven very far off course for very long is based on the view that prospects for the Canadian economy and for the Canadian balance of payments are fundamentally much better than they have been for some time.

If this view is correct, the Government's borrowing initiatives too may well come to be seen in retrospect as involving no great departure from the general modus operandi of a floating exchange rate regime. In my view they represent no more than a pragmatic and constructive response to a temporary situation in which the market's valuation of the Canadian dollar was being unduly affected by the apparent inadequacy of capital inflows in the short run, by the limited size of Canada's foreign exchange reserves, and by the concern engendered by the rate movement itself.

Looking further ahead, what can be said about likely scenarios and about the issues that may confront monetary policy with the necessity of making hard choices? The first thing I want to say is that if the next several years are anything like the past several years, we might as well resign ourselves to the probability that the surprises the future has in store for us -- nasty surprises as well as pleasant surprises -- will in practice have a much greater influence on the actual course of monetary policy from one year to the next than anything we can now surmise about the shape of the future.

Whatever the specific course of future events, it seems to me that monetary policy will need to be conducted for as far ahead as one can see within much the same broad framework as it is being conducted at present. To my knowledge no one today would argue that there is anything to be gained in the way of improved performance from our economy by inviting a revival of inflation. That means that monetary policy is going to have to continue to be very careful about permitting the pace of monetary expansion to speed up once again. At the same time, to my knowledge no responsible person would argue that inflation, once it has become deeply entrenched in our society, can be brought to an end very quickly, even with a degree of monetary restraint so severe as to involve unacceptably high costs in terms of foregone output and jobs. That means that monetary policy will have to continue to be very careful about permitting the rate of monetary expansion to fall so low as to choke off economic growth. The hard choices will lie between these extremes -- how to maintain a degree of continuing monetary discipline sufficient to help this country move over time towards more satisfactory levels of economic activity in an environment of receding inflation. Whatever surprises the future course of events at home or in the outside world may bring, they will no doubt continue to present monetary policy with hard choices having to do with the feasible pace and timing of further progress towards lower rates of monetary expansion and inflation. But to my mind the future is unlikely to present monetary policy with any reasonable option other than to press ahead in this direction as best it can taking due account of changing circumstances.

A statement by
Gerald K. Bouey
Governor of the Bank of Canada
before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs
Tuesday, May 16, 1978

I understand, Mr. Chairman, that you have asked me to come here today mainly to respond to questions that the Committee may have about recent developments in the exchange market. It might be helpful if I were to make a brief introductory statement and I am prepared to do so if that is the wish of the Committee.

Members of the Committee will appreciate that the policy governing the operations of the Exchange Fund Account is a responsibility of the Government, while the Bank of Canada, as fiscal agent for the Government, carries out the actual operations. This naturally puts us in a position to act as an adviser in this area. I would like to tell you how I look at two matters that I think will be of interest to you: first, the nature of the recent problem in the exchange market and, second, the kind of exchange rate system that we have in this country.

I want to begin by saying a few words about our underlying balance of payments position. Our competitive position in international trade has improved considerably as a result of some important adjustments in the economy over the last three years. Our performance so far as costs

are concerned has improved as rates of increase in money incomes have come back down to about the U.S. level, the expenditures of governments have been coming under much better control, the money supply is certainly under control, and we have had a very large exchange rate adjustment, one that, provided we contain the fall-out from it on costs and prices, produces a sutstantial improvement in our competitive position. Our merchandise trade balance has already improved considerably. Despite the continuing increase in our non-merchandise deficit, it is not unreasonable to expect our over-all current account deficit to decline from last year's level. On the capital account side, foreign borrowings by provinces and others are resuming on a substantial scale after a brief quiet period earlier this year.

This is not a picture of a country faced with a major balance of payments problem. On the contrary, the underlying balance of payments situation has been and is improving for the reasons I have just mentioned. But there have been problems. The lull in foreign borrowing a few months ago occurred at the time when the current account was weak for seasonal reasons and when the widespread weakness of the U.S. dollar may have been affecting attitudes toward our own currency. After a while the cumulative movement in the Canadian dollar itself became the most important aspect of the problem as it began to generate real concern about the immediate future value of the currency. Evidence for this could be seen in a number of developments, including a rapid build-up of foreign currency deposits of

Canadian residents who were switching out of Canadian dollars and in the circulation of completely unfounded rumours of exchange controls.

How should a problem of this kind, basically a problem of confidence, be dealt with? Not I believe by standing completely aside and letting the Canadian dollar fall as far as it might on the basis of market forces that had become heavily influenced by concern, or fears, about the immediate future of the currency. Although a floating exchange rate system has many advantages, and is indeed the only practicable system in today's world, it is asking a lot of the exchange market to move the rate a very long way without overshooting because of a developing problem of confidence. The trouble with standing aside was that the greater the fall in the exchange rate the greater the impact on our prices and costs, and thus the greater the danger that the progress we have made over the past three years would be undermined. We do not want to see a situation where exchange rate depreciation produces more inflation which, in turn, results in further depreciation -- a vicious circle.

At the same time, as I have already indicated, it was clear that Canada was far from having a balance of payments problem that required drastic measures of the kind traditionally relied on where the problem arises from excessive demand pressures overloading the Canadian economy. Nor were we obliged to take severe measures to defend an exchange rate pegged at some particular level.

The way to deal with the problem of confidence in the exchange market, while being as protective of domestic activity as possible, was to provide assurance that there would be a continuing inflow of capital to Canada adequate to finance our current account deficit since that deficit clearly could not be eliminated overnight. One way of achieving this objective was for the Government of Canada to take on, to the extent necessary, part of the job of raising capital abroad and to make arrangements that would leave no doubt about its ability to do so. That has been the purpose of its borrowings abroad and the establishment of its large standby credit arrangements. Another way was for the Bank of Canada to act to move short-term interest rates somewhat higher relative to rates abroad.

The increases in the Bank Rate in March and April were undertaken with a degree of reluctance because neither the present state of the domestic economy nor the recent pace of monetary expansion would, in the normal course of events, have seemed to call for any marked upward adjustment of short-term interest rates in Canada. However, the trade-off that was involved -- the avoidance of undue exchange rate depreciation with its inflationary consequences against somewhat higher short-term interest rates than would otherwise have prevailed for a time at least -- was, I believe, clearly worthwhile.

What has been accomplished has been the re-establishment of confidence that the bottom will not be allowed to fall out of the dollar,

and the floating exchange rate system has been preserved, with that system operating within a framework that has been modified at least for the time being by foreign borrowing by the Government.

I would like now to say a few words about how the exchange rate system operates. The first point I want to make is that no exchange rate system operates in a policy vacuum. Any exchange rate system operates within a framework of economic policies, including monetary and fiscal policies, and policies regarding the amount of foreign exchange reserves that are held and the extent of ready access to additional reserves. All of these factors have a bearing on the performance of the exchange rate regardless of the particular system.

The spectrum of possible foreign exchange regimes is a broad one but in general language "fixed" means a declared rate with small margins around it (the declared rate may be changed from time to time in discrete steps) and everything else is "floating". "Floating" does not mean that the authorities are barred from having an influence on the level of the exchange rate but normally their influence is exerted mainly by affecting the economic environment within which the market operates.

Possible "floating" exchange rate regimes can, in principle, range all the way from a position in which the rate floats freely without any official buying and selling of foreign exchange in the market to one where the degree of direct intervention can be so great as to prevent, on occasion

and for a time, virtually any movement in the rate. What one sees around the world are countries at different points in this spectrum at different times.

As a general principle it can be said that if the mix of monetary and fiscal policies, and other economic policies, is appropriate for the domestic economy, taking into account the objective of encouraging economic expansion while keeping inflation under control, the exchange rate that is thrown up by market forces operating within this environment should tend to settle down in an appropriate range. Changes in economic conditions, both here and abroad, and in the policy framework may well give rise, and often should give rise, to a change in the exchange rate. So long as the exchange rate is being determined within the over-all policy framework by normal market forces, any direct intervention in the exchange market by the authorities is likely to be designed only to smooth out short-term fluctuations but not to alter the underlying trend.

The scale and technique of intervention are always matters of judgment but in general the more volatile the rate, the larger the intervention. In most circumstances it is possible to conduct intervention with agnosticism about the rate. Various strategies are possible. One is that intervention may be carried out on a relatively moderate scale, and in a way that is symmetrical in the sense that the same degree of resistance is offered to movements that represent a weakening in the rate as to those

that represent a strengthening. The result is that foreign exchange reserves decline when the exchange rate is weakening, rise when it is strengthening, and show little net change if the exchange rate returns to its starting point. This has in fact been the strategy for most of the two periods since the war that Canada has been on a floating rate system -- 1950 to 1962 and again since 1970 -- and I believe it has worked well.

It does not follow that this strategy will work satisfactorily in exceptional circumstances. As I have said, experience here and in other countries indicates that a substantial movement in an exchange rate over a relatively short period tends itself to produce excessive expectations about the future of the rate, and can give rise to an unusual amount of speculative activity as well. In such circumstances the exchange market looks increasingly to the authorities to give some indication of the limit to the movement. Indeed, the market appears to expect that at some point the authorities will take action of the kind traditionally used to defend a fixed rate. A rather curious situation can develop in which the authorities continue to look to the market to determine the rate while the market insists on probing further and further to find out how far the rate will be allowed to move before the authorities step in. A stage can thus be reached where the authorities have little choice but to become more heavily involved.

If the exchange rate is judged to be moving too far too fast the authorities have certain options as to how to react. The environment

in which the market operates can be influenced by changing the policy framework; for example, an adjustment to short-term interest rates can be brought about. Another possibility is to change the scale and pattern of official intervention in the market in order to provide resistance that becomes stronger the further movements in the exchange rate go. If this is done in a period in which the exchange rate is weakening, reductions in the level of reserves will become greater relative to any given decline in the rate; the rate continues to float but it encounters increasing resistance as it floats down.

A reduction in the level of foreign exchange reserves can be described as a way of supplementing the inflow of capital into Canada because the Government is supplying foreign currency to the market in exchange for Canadian dollars. The Government can use its existing currency reserves for this purpose and it can also acquire additional reserves by borrowing abroad.

Unless the Exchange Fund Account "digs in" at a specific point to halt any further movement in the rate, and it has not done so, the views of the market continue to play an important role in the determination of the rate for the rate continues to be free to move over time. The ability and willingness of the authorities to be more active in the market, and to put foreign currency resources into the market, naturally influences the market's view of what exchange rate will balance the market. Once a

reasonable degree of confidence that extreme cumulative movements in the exchange rate will not occur has been firmly re-established, it may well be that the need for large scale intervention will disappear and the exchange market will operate more in the way to which we have been accustomed.

NOT FOR PUBLICATION BEFORE: 1:00 P.M. EASTERN DAYLIGHT SAVING TIME, SEPTEMBER 21, 1978

REMARKS TO THE
SWISS-CANADIAN CHAMBER OF COMMERCE
MONTREAL, SEPTEMBER 21, 1978
BY R.W. LAWSON
SENIOR DEPUTY GOVERNOR, BANK OF CANADA

Remarks to the
Swiss-Canadian Chamber of Commerce
Montreal, September 21, 1978
by R. W. Lawson
Senior Deputy Governor, Bank of Canada

As you know, I have not committed myself to a specific topic for my remarks today, and I am going to take advantage of my freedom to start with some very general comments on the economic aspects of affairs.

I have been an observer of economic affairs for a long time, and in the perspective of my lifetime the thing that impresses me most about the current economic scene is the prosperity of the industrial world. If anyone had told me in the late 1930s that the industrial world would be as prosperous as it is in 1978 I would have regarded that view as wildly optimistic. I think of this whenever I come across, as I occasionally do, suggestions of similarities between the current Canadian economic scene and that in the 1930s. No one who knows anything about the 1930s in Canada can take such references seriously.

But if at that time I had been able to foresee the current prosperity of the industrial world I would certainly have supposed that the economic

strains and stresses of today would be a great deal less than they are. Even in retrospect I am surprised that this has not happened. Why are the problems of managing economic prosperity as difficult as they are?

I know that our current economic problems are not usually described in terms of managing economic prosperity. What is more frequently emphasized is the extent to which current levels of real gross national product in one country or another are below some potential level. There is in fact such a gap, but it is quite small relative to the total growth in output and income in the industrial world over the last forty years. That growth has been phenomenal, and must surely be one of the wonders of economic history.

Why then, when the output and income of the industrial world have grown so enormously and are so high, does that world seem to be so beset by economic problems? Why is the economic atmosphere so charged with a sense of difficulties?

That is of course far too difficult a question to be answered adequately in a luncheon address even if one were sure he knew the answer. I shall nevertheless venture some comments on it.

I don't personally doubt that the immediate explanation of much of the current economic uneasiness in the industrial world is a direct or

indirect consequence of inflation. I shall say a good deal today about the consequences of inflation, but before I proceed with that I would like to say something about an aspect of current attitudes to economic matters that seems to me to underly inflation and to contribute to it.

What I have in mind here is the idea that one frequently hears that the extraordinary economic successes of our industrial societies in recent decades have themselves contributed to our current problems by generating economic expectations about the future that are unrealistic. I think that there is something in this view.

The thing that I find to be most unrealistic about economic expectations is that they count on a continuing rapid increase in real income without giving anything like adequate attention to what is required to achieve the increase in production that makes an increase in real income possible. They count on the goose to lay larger and larger golden eggs without looking to the care of the goose. Rapid and sustained growth in real income cannot be achieved by assuming it; it must be earned by efficient effort in a highly competitive world.

I am here touching on the question of economic incentives in our societies. With due regard to the world's environmental problems I do not see any serious impediment to substantial further economic growth in our societies if the structure of incentives encourages it. But to plan to

consume what a country's citizens are not willing to produce within the structure of incentives to produce that exist in the society is to ask for trouble. Such planning is, I fear, a not uncommon feature of the current economic scene.

How, one might ask, can it be that some of our societies seem to expect to reap what they are not willing to sow? I suppose that the answer to that lies mainly in the complexity of our modern societies. From the point of view of an individual the link between sowing and reaping has become somewhat attentuated. You will have no trouble in thinking of a variety of contemporary social practices that work in this direction. These practices undoubtedly have many advantages but they also have the disadvantage that, if more needs to be sown, it is easier for each of us to comfort himself that it is somebody else's responsibility to do it. We thus have a problem of incentives in our societies.

I believe that the problem of incentives has been exacerbated by the inflation of recent years because the inflationary process has further attentuated the link between economic contribution and economic reward. The rapid erosion of the purchasing power of money incomes has unquestionabl shaken people's faith in the fairness of the economic system, and has diverted their attention from concern with the production of income to concern with its distribution. This has fostered much more adversarial attitudes between

groups in our societies. Of all the consequences of inflation the worst in my opinion is the way that it erodes the co-operative spirit among the various groups in a society. That erosion is really dangerous for a co-operative spirit is the foundation on which civilized society rests.

What I have been suggesting in these references to incentives is that some of our societies have been dazzled by their post-World War II economic successes and have grown casual about the requirements for further economic success. In this country at least, that state of affairs seems to me to have been a contributing factor to the surge of inflation that we had in the first half of the 1970s because it encouraged the belief -- widely held for a time, and even now still flourishing in some quarters -- that if we in Canada would only keep on expanding money incomes and expenditures fast enough the goose could be relied on to do her bit -- a high and rapidly rising flow of Canadian output (in real terms) would pour forth. Whatever the merits of that view of economic dynamics, it was pushed too hard at that time. The incentives to produce were not strong enough to give rise to the desired increase in production and we got unwanted inflation instead. We have been living with the debilitating consequences of that ever since.

A good example of how inflation has recently been complicating Canada's economic life is to be found in our international trade. In the

last two years or so we have continued to run a large deficit in our international trade in goods and services despite the fact that we have had a significant amount of unemployed resources in our economy. The basic reason for this is that the costs of Canadian production have risen too much relative to foreign production to permit Canadian production to be sufficiently competitive in international markets.

That situation had consequences for the foreign exchange value of the Canadian dollar. Although there were other important contributing factors, the main reason that the Canadian dollar has declined so much in exchange markets over the past two years is that Canadian production has not been sufficiently competitive with foreign production to avoid a substantial change. One should note, however, in this context that the exchange rate for the Canadian dollar has been much weakened in recent weeks by the appearance in two consecutive months of figures on Canada's international trade that were very much weaker than had been expected. These figures recorded for the two months no significant surplus in our international trade in goods, whereas Canada needs to have large net exports of goods to offset our large net imports of services, including business and travel services and interest and dividends on our large external indebtedness. The unexpectedly weak trade figures naturally raised the question of whether Canada's competitive position in international trade was not much weaker than had been supposed, and the exchange market reacted accordingly.

I myself have no doubt that when it becomes possible to assess these figures in perspective they will be found to have been quite misleading as indicators of Canada's competitive position. The situation is not nearly as bad as those figures suggest, and when in due course that emerges the exchange market will presumably react in the opposite direction.

It was, in my opinion, a happy event when in the course of 1975 public policy in Canada swung from trying to learn to live with inflation to trying to learn to live without it. I have also welcomed the subsequent initiatives of the federal and provincial governments that are directed to the same end.

I would like to be as clear as possible about why I am in favour of learning to live without inflation, and opposed to trying to live with it. The reason does not lie in some arcane central banking belief in monetary stability as an end in itself but in the basic economic proposition that market societies do not and cannot function well under continuing inflationary conditions. In such circumstances they do not and cannot produce what their citizens want from them, namely, stable prosperity. If a society wants stability and prosperity it should avoid inflation like the plague. I do not claim that this proposition is self-evident but I am sure that it is true. Its truth is now strongly supported by a large and rapidly growing body of economic experience around the world.

The consequences of this economic proposition for public policy are of course enormous. They penetrate virtually every aspect of our economic life. They are obviously profound for the aspect of public policy in which I am directly involved, namely, monetary policy, and I shall concentrate on that aspect of policy in the rest of my remarks today. I do this because that is where my responsibility lies, and not because I think that good monetary policy is a sufficient condition for good performance of a market economy. While I am certain that "money matters" I am sure that it will be clear from what I have already said that I do not believe that "only money matters". But let me turn to money.

It is, I take it, a truism that price inflation cannot continue unless it is financed by monetary expansion. That is why the Bank of Canada is following its present policy of reducing over time the rate of monetary expansion in Canada. As you know, we are doing this gradually rather than precipitately, and the reason for the gradualism is to avoid the intense economic disruption, and the social reaction, that would inevitably be involved in a deliberate precipitate change in the financial environment.

As you know, we in the Bank of Canada have been pursuing this policy of moderating gradually the rate of monetary expansion in Canada by the practice of publishing a target range for the future growth of the

money supply narrowly defined (M1), and then each year or so lowering the target range. Last week we published the fourth target range in this series. The new target range is from 6 to 10 per cent annually, and it replaces a range of 7 to 11 per cent chosen last year, 8 to 12 per cent the year before and 10 to less than 15 per cent announced in the fall of 1975. We are thus making progress in reducing our target range.

Having targets is of course of limited value if one does not have some success in hitting them. I should therefore add that for each of the three periods for which we have had them we have come well within our target ranges.

That, briefly, is the story of monetary policy in Canada in the last three years and its posture for the future. We have so far managed to follow much the path for monetary expansion that we wanted to follow, and we intend to press on. We have been much encouraged by the support that our policy has received, and we hope for the continuation of that support.

One serious problem with the gradualist approach to reducing inflation is that it requires from everyone so much perseverance and patience. It's hard to imagine how any conjuncture of events could illustrate that better than the price and cost situation in Canada today.

Over the past three years the path of price inflation in Canada as measured by the various price indexes has been rather erratic. The main reason for this has been the volatile course traced out by food prices both here and in the United States. Several largely unrelated forces have pushed food prices around a lot in North America over the last three years -- restraining them during 1976 and then driving them strongly upwards to a peak which seems to have been reached at about the middle of this year. In Canada an additional factor putting strong upward pressure on prices -- both food and non-food prices -- has been the substantial decline over the past two years in the foreign exchange value of the Canadian dollar.

One can of course not ignore food prices or the effect of the exchange rate on prices, but if one makes allowance for them in analysis he finds that the upward pressure on prices in Canada from all other sources has moderated substantially and more or less continually over the past three years. This has arisen fundamentally from the moderation that has occurred in the rate of upward movement of labour costs. This development is cheering, for a reduced rate of inflation of Canadian costs is exactly what the country needs to strengthen the base for its future prosperity. In my opinion there is at present far too little recognition both at home and abroad of the extent and importance of the moderation that has been achieved in the underlying trend of Canadian costs. The main reason for this probably is that this favourable underlying development has

been obscured for some time in the price indexes by the rising food prices and the declining exchange rate. There is, however, now a good prospect that it will soon emerge as the main determinant of the trend of Canadian prices.

The big danger in the present situation is that the recent upward surge in the Consumer Price Index caused by foods and the exchange rate will lead to a reversal in the moderating trend of production costs in the Canadian economy. There is absolutely no doubt but that the wage and salary structure in Canada is now under great upward pressure from consumer prices. In many cases individual real incomes have fallen over the last year, and in many more cases they have risen less than was expected. That is a situation which produces unhappiness and a sense of grievance, and it strengthens the urge of those affected to use whatever means are available to push for large increases in money incomes.

The trouble is that a new burst of inflation of incomes will not ease the national problem, but will rather compound it. It will reverse the progress we have made in recent years towards establishing the basis for stable prosperity. Another outburst of wage and salary inflation will mean that we shall have to go through the painful sobering-up process from the beginning all over again. One must therefore devoutly hope that Canadians will find it possible to show sufficient restraint in the months ahead to avoid an acceleration of cost inflation. One must hope that they

will be wise enough to recognize that the burst in consumer prices is temporary and that it should be met with moderation and patience.

Because of the critical importance of a successful passage through these difficult waters it is natural to ask what the central bank can do to ease that passage. In our view the main thing it can do is to show resolution in its policy of gradually reducing the rate of monetary expansion, and to demonstrate thereby that it is not willing to finance a renewed outbreak of inflation. We regard the Bank's new lower target range for the rate of monetary expansion as evidence of this resolution. Within this framework the Bank has also taken some interest-rate initiatives to moderate the rate of change of the exchange rate. The Bank's concern in this area arises from the fact that the exchange rate movement has been reinforcing the upward surge of consumer prices and has thereby been adding to the intense pressure on the wage and salary structure. In current circumstances it would be preferable to have the effect of exchange rate depreciation on consumer prices spread over a longer period of time. Another aspect of the exchange rate that has concerned the Bank is the well-known fact that exchange rate movements that gather momentum usually go farther than the situation warrants, and indeed this may already have happened in Canada.

I want to say very clearly that in taking these initiatives the Bank had no intention of establishing or protecting any particular exchange

rate. The Bank shares the view that the exchange rate should remain free to respond to changes in the country's competitive position in international trade and in other elements in its external financial position. Among these other elements are the differentials in interest rates between Canadian and foreign markets. These differentials have an influence on the international movements of capital and on the balance of supply and demand in the exchange market. By affecting these differentials through Bank Rate action the Bank of Canada has changed somewhat the environment within which the exchange market operates without restricting the freedom of the rate to move in the changed environment.

That concludes my remarks for today, and I am going to stop without any attempt to summarize them. I would like to add, however, that I do not feel discouraged in respect of the concerns that I have expressed. On the contrary, I am much cheered by the movement in Canada and abroad towards what I consider to be a more realistic appreciation of economic processes and a more realistic approach to policy. I believe that these changes are greatly improving the prospects for good economic performance in the future.

NOT FOR PUBLICATION BEFORE: 8:00 P.M. CENTRAL STANDARD TIME
9:00 P.M. EASTERN STANDARD TIME

THE MANAGEMENT OF MONEY

REMARKS BY R.W. LAWSON
SENIOR DEPUTY GOVERNOR OF THE BANK OF CANADA
TO THE PROFESSIONAL ACTIVITY DINNER
OF THE INSTITUTE OF CANADIAN BANKERS
WINNIPEG, MARCH 29, 1979

THE MANAGEMENT OF MONEY

REMARKS BY R. W. LAWSON
SENIOR DEPUTY GOVERNOR OF THE BANK OF CANADA
TO THE PROFESSIONAL ACTIVITY DINNER
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WINNIPEG, MARCH 29, 1979

I am also pleased to be able to participate in this evening's occasion. As I understand it the principal purpose of this occasion is to take note of the activities of the banking community in encouraging and facilitating the broadest possible training for bankers and the highest possible professional standards in banking. To those ends The Canadian Bankers' Association formed the Institute of Canadian Bankers in 1967 to expand the CBA's educational activities. While I have never seen a complete list of the educational initiatives that the Institute has taken I have seen enough of them to be greatly impressed by them, and particularly by the range of topics they cover. I am not surprised by this wide range because I am also greatly impressed by how much a good banker needs to know and how many fields he or she must learn to work in. Both to those who are directing the Institute's programmes and to those who are participating I extend my congratulations and best wishes.

My topic tonight, The Management of Money, is itself a good illustration of the wide range of the banking business because a wide variety of quite different activities could be equally properly discussed under that title. One could discuss commercial banking or savings banking or investment banking or international banking or the money market or the mortgage market or the bond market or the stock market or the foreign exchange market. And he could also discuss central banking, which is of course why I chose that topic.

But what I most want to do this evening is not to focus on any financial events in themselves but to invite you to look at some of them from a point of view outside the financial world. I want you to look at them from the point of view of what economists call the "real" world.

I am always amused at this phrase "the real world" because it seems to imply that the financial world is unreal, that it is some sort of illusion. Those of us who work in it know that it is no illusion, but I doubt that any of us would question the merit of distinguishing between the financial and the non-financial, or real, aspects of events. We know that the role of finance is to facilitate real things -- things like employment, productivity, output, trade and the standard of living. These are things that really matter. The importance of financial events arises from the fact that they affect these things.

The business of looking through financial events to their effects on the real world -- the business of looking through the financial veil -- is not easy. That is presumably why so much nonsense is talked about financial matters, and especially about financial policy. A lot of the nonsense comes from failing to analyze financial proposals in terms of their full effects on the real world. Until that is done there exists no solid basis for judging their merits.

I speak of these matters with some feeling for I have spent most of my professional life in an institution, the Bank of Canada, that lives in the financial world but that is interested in financial matters primarily as a means of affecting the real things that I have mentioned. Those are the things that central bankers are really interested in. Our job is to influence the financial world in such a way as to promote those things. There is a persistent view that central bankers are interested in financial things like stability in the value of money as ends in themselves. I assure you that that is not so. Our job is to look through the financial veil and we know it.

But it is not enough to look through the financial veil ourselves; we must also persuade others to see through it. To discharge its responsibilities the Bank of Canada has to succeed in doing both things. It has to discover and follow policies that best promote the economic

life of the nation, and it has also to persuade the country that its policies are in fact well designed to that end. In a democratic society a central bank must have support in the society for its policies. It therefore behooves a central bank to explain to the society why its policies merit support.

In that sense the Bank of Canada is also involved in the educational business. One of the Bank's principal initiatives in this area is its Annual Report, formally described as the Annual Report of the Governor of the Bank of Canada to the Minister of Finance. The Report for the year 1978 was completed on February 28 of this year and was tabled in the House of Commons by the Minister of Finance a week ago. I strongly urge anybody interested in banking or, for that matter, in financial and economic affairs generally, to get a copy and read it. I think I can assure you that it is a readable document and that you will find it interesting. It certainly involves a major effort by the Bank to explain its policies within the current economic environment. Copies of the Report are now available on request without charge from our Agencies across the country or by writing to us in Ottawa. Copies of a reprint of the first part of the Report are also available and we have brought quite a few for distribution here this evening to those who are interested.

That concludes my direct sales pitch for the document. I want now to talk a bit about some of the problems that arise when one sets out to prepare a document like our Annual Report, that is, when one sets out to talk about central bank policy in a way that he hopes will be readily understood by people who are not specialists in monetary matters.

The preamble of the Bank of Canada Act gives as the first reason for establishing the Bank this one: "to regulate credit and currency in the best interests of the economic life of the nation." Those words were written in the mid-1930s; had they been written in today's terms they might well have read "to regulate the money supply in the best interests of the economic life of the nation", because that is a more precise description of the channel through which the Bank of Canada can influence the real world.

It seems appropriate in these circumstances to ask what is this money supply that the central bank is supposed to regulate?

Before one can measure the amount of money in a country he has to know what money is. What is money? Can you tell money when you see it? Curiously enough, it is not easy. We in the Bank of Canada have not yet discovered a definitive definition of money for purposes of measuring the amount of it, and we doubt that there is one. We know

that coin and Bank of Canada notes are certainly money, and we know that chequable deposits with financial institutions are used in place of coin or bank notes to make larger payments so for practical purposes they too are clearly money. But what about savings deposits? or personal term deposits? or corporate term deposits? or treasury bills? or other so-called money market paper? or Canada Savings Bonds, that are as you know cashable at par on demand? or highly liquid marketable securities? All of these have some qualities of money in that they are to some extent substitutes for money. If you want to go on, what about credit cards or charge accounts or overdraft facilities or credit lines? These are also to some extent substitutes for money. Since it is not at all clear where to draw the line in the spectrum of financial assets that have some money-like characteristics the result is that there can be about as many measures of the money supply as anybody wants to prepare.

This state of affairs is, fortunately, not nearly as serious an obstacle to good monetary regulation as one might suppose. Part of the reason is that all the main measures of the money supply have a considerable tendency to move together, and when that is the case it makes little difference which measure one looks at. But they do sometimes move quite differently -- what does one do then?

The theoretical answer to that is that if different measures of the money supply move differently there are reasons for it, and one needs only to discover the reasons and then he can use, with appropriate allowances, any one he wants. In theory, therefore, there is not an overwhelming case for using one measure rather than another.

In practice, however, some measures of the money supply are much harder to use for policy purposes than others because the reasons for their movements are more complex. That means that they are harder to interpret on a month to month basis and they are more difficult, in some instances virtually impossible, to forecast in the Canadian context. To go into this question in any depth gets pretty technical and I shall not pursue it here, but there is a short, and I think good, piece in the Annual Report about why we in the Bank of Canada have chosen to use a narrow definition of the money supply, namely, currency and chartered bank demand deposits held by the general public -- the so-called M1 -- for purposes of expressing our targets for future monetary expansion. Our preference results from having given a great deal of study to the question, and our studies have convinced us that, while targets expressed in other terms are possible, M1 is, as a practical matter in Canada at present, the best target variable. But we keep on reviewing the matter and we are always pleased if people who think otherwise will expose their studies to us. It is certainly our judgment that our policy over the last three years

is better than it would have been had we expressed our targets for monetary expansion in terms of some much broader definition of the money supply.

Let me turn now to another aspect of monetary policy, namely, how it works. Other things being equal a different rate of monetary expansion will cause the price or availability of credit to be different, and this will influence people's decisions about the amount of their spending. The influence will be felt directly and also indirectly through the exchange rate. It is thus by influencing total spending through changes in the price or availability of credit that monetary policy affects the real world.

By the price of credit I mean of course the rate of interest paid on borrowed money. By availability I mean all the non-price terms, but mainly whether the would-be borrower can find anybody willing to lend to him at the going price for loans of comparable risk. It is not difficult to imagine financial systems that make quite a lot of use of non-price factors in the distribution of credit but in Canada today credit is distributed very largely on the basis of price. I am happy about this because my experience with non-price rationing systems has not commended them to me. There have in the past been features of the Canadian financial system that gave rise on occasion to significant elements of non-price rationing of credit. The earlier 6 per cent statutory limit on the interest rate for bank loans

is an example. If at that time the banks were faced with more demands for loans than they could satisfy at 6 per cent they had to ration their credit on some non-price basis. At present there are, however, very few features of the Canadian financial system that give rise to any use of non-price rationing of credit. In Canada, therefore, it is primarily through the direct and indirect influence of interest rates on people's spending decisions that monetary policy affects the real world.

In respect of the impact of interest rates on the exchange rate, that also is both direct and indirect. The direct effect is through international flows of capital. While some flows of capital into or out of Canada are insensitive to interest rates most of them are sensitive to some degree and many of them are very sensitive. But interest rates also have an indirect effect on the exchange rate through their effect on the levels of over-all spending in Canada because virtually all spending in Canada affects either imports or exports.

The exchange rate of the Canadian dollar has been much in the news in the last year or two, and you will find a good deal of comment on it in the Bank's Annual Report. You will find there an explanation

of why the Bank of Canada was concerned about the speed and cumulative magnitude of the depreciation of the Canadian dollar in 1978 and why the Bank considered it desirable to avoid the additional downward pressures on our dollar that would have emerged if the Bank had allowed interest rates in Canada to rise less rapidly than in the United States. The argument is not difficult -- it is that the continuing rapid decline of the exchange rate during 1978 was adding so much to the rate of increase of consumer prices in Canada as to threaten another outburst of large wage and salary increases. To the extent that the decline in the exchange rate is offset by an acceleration in the rate of increase of wages and salaries, and thus of costs of production in Canada, the whole exercise becomes futile.

In conducting monetary policy we in the Bank of Canada try to follow the advice much favoured by almost all athletic coaches, namely, keep your eye on the ball! And the ball in this case is the cost of production in Canada.

If you look at events in this country in the perspective of the last ten years or so what you see is that in the first half of the 1970s Canada got into pretty serious economic trouble, and one of the main signs of that trouble was a rapidly accelerating inflation of costs and prices. A lot of things contributed to that trouble, some of foreign origin and

some of domestic origin. The situation seemed to me to be getting worse until the summer of 1975, and then something happened. Canadians seemed to wake up that summer to the fact that they were in economic trouble and were headed for worse trouble. There emerged rather quickly a considerable consensus that the interests of the country required that policies and practices to moderate inflation be followed throughout the economy. Many Canadians gave up their earlier disposition towards the comfortable view that inflation was something that they could blame on the rest of the world.

I'm not going to try to explain what produced this rather sharp change in the national mood for I'm not sure even now that I could assess properly the relative importance of the several elements that contributed to it. But I want to say that we in the Bank of Canada had been trying to encourage it. We had become very concerned about the way things were going and we decided that we must find some way to give clear public expression of our determination to reduce gradually the rate of monetary expansion in Canada. That was first done in a speech by the Governor, Mr. Bouey, in September of 1975 in Saskatoon. The views expressed in that speech attracted a good deal of attention and a good deal of support.

The change during 1975 in the national mood has had profound and beneficial consequences. I think it is fair to say that since then the policies and practices of virtually all the main groups in Canadian society have been less inflationary than they were, and one consequence is that the rate of inflation of costs of production in Canada is now well below its 1975 peak.

If the cost of production in Canada is the ball to watch, the game is to slow the growth of these costs. We have until quite recently been winning this game, but at the moment the going is tough. We are not in fact doing very well in the present innings and we are in danger of losing some innings if we are not very careful. Our problem is to contain two forces which we cannot escape. One is an increase in some food prices relative to other prices and the other is a decline that has occurred in the value of our currency relative to other currencies.

Both of these forces were generated by the inflationary excesses of the first half of the 1970s, and they both have to be absorbed. They are the proverbial chickens coming home to roost. Their absorption is painful because it involves the transfer of real income -- the transfer in one case of income from consumers of food to producers of food,

and the transfer in the other case of income from Canadians to foreigners. These transfers reverse transfers in the opposite direction that occurred a few years ago. To try to avoid them by an inflation of money incomes would be like trying to sober up on whisky.

The strategy in 1978 of moderating the cumulative depreciation of the Canadian dollar was not a strategy to escape the real cost of correcting Canada's balance of international payments. It was rather a strategy of spreading that cost over more time so that it can be absorbed with less pain -- and therefore with less danger of futile efforts to escape it.

The upward pressure on prices and costs generated by the exchange rate depreciation, supplemented by the relative rise in food prices, has already led to some upward drift in the rate of growth of money incomes in Canada. As long as this drift continues we shall lose some innings in the game. If the drift becomes a strong upward surge we shall lose the game. If that happens we shall have to bind up our wounds, summon up our courage, and start all over again.

Let me pause here a moment to emphasize the importance of seeing events like these in sufficient time perspective. Patience is not the great virtue of our age but it is nevertheless surprising to me to observe how many people seem to think that economic policy ought by now to have moved into the polaroid camera age -- click, and there the results are. But time is of the essence for economic processes. Sometimes the short-run effects of financial policy on the real world are quite different, even in the opposite direction, from the longer-term effects. And the longer-term impact may take several months to show at all and a few years to be fully felt. This rather long time framework poses a real problem for public policy because of the tendency of both observers and participants to look for instant results. How can one urge patience in economic matters without seeming to be insufficiently concerned?

To return to my main theme that production costs are the ball and that the moderation of their rate of increase is the game, the game is worth winning because the prize is economic prosperity. If we can show enough restraint to absorb the costs of the exchange rate change we shall be in good shape to benefit in the years ahead from the restored international competitive position that the exchange rate change has brought. Our economy is already responding strongly to the stimulus

of our current strong competitive position in international trade. Strength in employment and output is apparent in virtually all of the industries that export and those that compete with imports. An economic expansion driven by external trade is exactly what this country needs, and it is happening. There are already signs that that expansion is being limited by a shortage of plant capacity, but business profits are rising and providing desirable incentive for an increase in plant capacity. That process also involves some re-transfer of income. An increase in plant capacity to produce internationally-traded goods has begun, and if it continues it will permit a continuing strong growth of employment in Canada. The greatest threat to this promising economic prospect is that we indulge in another burst of wage and salary inflation as we did some five years ago. That would blow it.

As to what our chances really are of exploiting our current economic opportunities you may be as well placed as I to judge. It depends a lot on how sensible the various groups in our society will be. You will, I think, know what I mean by that. If the various groups in our society, public and private, urban and rural, employers and employees, are reasonably tolerant and cooperative in their economic

conduct, if they will give at least as much time and effort to trying to increase the size of the national economic pie as in trying to achieve a distribution of it that pleases them, then the kinds of adjustments I have been talking about will be accommodated without great difficulty. The economy will work better, and that of itself will ease the strains. But if the various groups in the society focus only on their own immediate interests the flexibility to accommodate economic adjustments will be lost. A kind of economic arthritis will have set in, the economy will not work well, and all the groups in the society will be disappointed.

The Canadian economy is now being put to the test. While I am hopeful, I do not pretend to know how well it will respond. What I do know is that we in the Bank of Canada have no intention of revising upwards our monetary targets to finance a resurgence of inflation. We hope that this approach to managing money will encourage others in the economy to act moderately.

Statement prepared for the appearance of

Gerald K. Bouey

Governor of the Bank of Canada

before the

House of Commons Standing Committee

on Finance, Trade and Economic Affairs

Thursday, October 25th, 1979

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of Gerald K. Bouey, Governor of the
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I am glad to have this opportunity to explain the recent actions of the Bank of Canada to this Committee.

I think I know why you want to see me. You are concerned about the high levels reached by interest rates in Canada. You are disturbed about the effect of these interest rates on borrowers, both individuals and businesses. You are also disturbed about the effects of these interest rates on the near-term prospects for employment and growth in the Canadian economy.

There is no question but that interest rates as conventionally stated are very high. In terms of our history they are at record levels. The interest rate charged by banks on demand loans to prime borrowers is 13 3/4 per cent; other borrowers pay more. Housing mortgages are in the 13 1/4 to 13 3/4 per cent range. The interest yield on long-term Government of Canada bonds is about 11 1/2 per cent. Savings depositors can obtain rates in the neighbourhood of 11 per cent. I am not surprised that these rates have aroused a good deal of comment and criticism. Certainly anyone who looks no further than the immediate impact of the high level of interest rates is bound to feel concerned about what has happened.

I would like first to comment directly on these concerns and then go on to talk more generally about the economic and financial situation as I see it and what the Bank of Canada is doing about it.

With respect to the level of interest rates I would first like to remind you that "it takes two to tango". If there is a borrower there must be a lender, and one needs to look at the situation from his side as well. Lenders are usually thought of as banks or other financial institutions but it is more accurate to regard those institutions as intermediaries. The true lenders are the savers, the Canadians who hold deposits with banks, trust companies, credit unions and caisses populaires, who have life insurance policies, who contribute to pension funds and who own bonds. To lenders, interest rates do not look all that high because they know that the interest they receive is in effect reduced by the declining purchasing power of the money they have loaned and will eventually get back. Of course borrowers know this too; they know that the real cost of borrowing is nowhere near as high as the level of interest rates makes it look.

What I am saying here is that the nominal level of interest rates must be set against the rate at which inflation is reducing the value of money to discover the level of real interest rates. It is real interest rates much more than nominal interest rates that affect people's decisions, and thus the way the economy performs.

One problem with real interest rates is that of knowing what they are at any moment in time. The real interest rates that affect economic decisions are those obtained by adjusting current nominal interest rates by the future rates of inflation that people expect to occur. Since it is not easy to measure people's expectations it is not possible to be precise about what real interest rates are at any given moment or indeed were in past periods. One can, however, arrive at an approximate estimate of the real rates that prevailed in the past by adjusting historical interest rate levels for the associated rates of inflation. During this century it can I think be said that real interest rates in Canada have typically been in the range of 2 to 5 per cent depending on the degree of risk involved in the loan and its term to maturity. During periods of inflation they have often been well below that range, and in recent years they have sometimes turned out to be negative -- a state of affairs that could not reasonably be expected to last because it imposed no real cost whatsoever on borrowers and penalized rather than rewarded savers. Interest rates in Canada at present are presumably seen as being positive in real terms, but I judge from observing how borrowers act that in real terms rates are not seen as being extremely high. Real interest rates in Canada have typically been somewhat higher than in the United States because Canada has long been an importer of capital. The argument that real interest rates in Canada are higher than usual in relation to U.S. rates depends on the view that the outlook for prices in Canada -- including energy prices -- is not nearly as bad as in the United States.

Let me turn now to the other concern that I mentioned in my opening paragraph, namely the effects of current interest rates on the near-term prospects for employment and output in the Canadian economy.

There is a problem here and it is very important to understand its nature. No one who examines the matter can fail to see that the prospects for economic activity and employment in the months ahead are less than ideal, in part because of a probable short-term slowdown in economic activity in the United States. If this were our only economic problem we could concentrate on it alone, but it is not. We have another problem, and that is the threat posed to the future growth of employment and output in this country -- and in many other countries -- by yet another resurgence of inflation. This is a longer-term problem and in my opinion it is a much more serious one. Nor am I the only one who thinks so. The threat of inflation to the world's future economic prosperity was in fact the major theme running through the statements of the major industrial countries at the annual meeting of the International Monetary Fund, which I attended earlier this month. Declining confidence in the future value of money is threatening the future performance of almost all market-oriented economies because economies that use money cannot work well when the future value of their currencies is in serious doubt. The gold market has recently offered dramatic evidence of the expectation and fear of inflation that has developed around the world and the sight of Canadians lining up to buy gold is not reassuring.

If the objective of public economic policy is to seek conditions in the years ahead that are favourable to economic prosperity, then inflation must be fought and public expectations of high inflation must be reversed. The experience of other countries shows that if inflationary tendencies are not fought earlier they have to be fought later and that the later the battle is joined the more painful it is bound to be. Whatever the merits in earlier periods of taking policy risks only on the side of inflation, that approach has now become far too dangerous. With that approach inflation accelerated during periods of economic expansion, paused on a plateau when the economy slowed down a little, and then accelerated again. If pursued continuously that course could only lead to economic and social breakdown. I believe that we have gone as far along that path as we dare.

For some time now the Bank of Canada has been trying to improve prospects for the functioning of the Canadian economy in the years ahead by following a monetary policy directed towards resisting any acceleration of inflation and encouraging its gradual reduction. That policy has meant resisting inflation coming from external sources through our international trade and our foreign exchange rate as well as inflation generated or accommodated internally by the growth of money and credit. I should like to discuss these two aspects of the situation, starting with our international trade and the exchange rate.

Canada's external payments deficit on current account has been widening again this year and now appears to be running at a rate of

around $7 billion a year. Among the major industrial countries this is the largest current account deficit in relation to GNP and it may even be the largest in absolute terms. This is both disappointing and worrying in view of the fact that we have already had a large downward adjustment in the external value of our currency. That decline in our exchange rate has re-established our competitive position in the world. However, in many of our export and import-competing industries business has increased to the point where they are now operating at or close to existing capacity and thus have no further scope at present to exploit their new opportunities. Efforts by these industries to increase their productive capacity are underway but this will take time. Until these increases in productive capacity are achieved we shall not be in a position to reap the full benefits of our improved competitive position.

In the meantime the current account deficit must be financed one way or another. If it is to be financed without a further significant depreciation of the Canadian dollar, interest rates must be high enough in Canada to attract an adequate inflow of funds into this country and to discourage capital outflows. There may be periods when flows of funds in response to other incentives, for example, investment prospects in energy development, may be strong enough to allow short-term interest-rate spreads to be unusually low or even, for a time, non-existent or negative. But in circumstances where interest rates abroad are rising as rapidly as they have risen in recent months and where doubts remain

about the ability and determination of Canadians to avoid further exchange rate depreciation, the scope for Canadian interest rates to lag behind foreign rates is necessarily rather limited unless we want to invite yet further substantial depreciation of the currency.

Some people have suggested that the Bank of Canada should not worry about these interest rate relationships, that it would be preferable to try to hold Canadian interest rates well below current U.S. rates and allow the Canadian dollar to fall in the exchange market to whatever level this might involve. It is important to recognize what the consequences of such a course of action would be. Even if the Canadian dollar declined sharply in value it would take a long time for that change to have any major effect on the size of the current account deficit for the reason that I have already mentioned, namely, that few of our industries have the existing unused capacity to take advantage of such a change. In the absence of an adequate inflow of capital attracted by interest-rate incentives and because of the outflows that would be generated by a lack of confidence in the value of our currency, the Canadian dollar would have to decline far enough to convince investors that it had clearly become undervalued, at which point a short-term capital inflow could be expected to emerge and to check the decline. Meanwhile the price level in Canada would have been pushed even higher by the fall in the dollar and unless Canadians were prepared to accept the resulting decline in their living standards this in turn would

lead before long to a further acceleration of the wage-price spiral and a further weakening of the exchange rate. Once started, this vicious circle of exchange depreciation and rising inflation could be expected to continue until interest rates rose sharply enough to stop it.

In short, our internationally exposed industries are already in a strong competitive position and in present circumstances a significant further depreciation of the Canadian dollar would do much more harm than good. It would worsen our inflation problem and prejudice our economic prospects. I invite you to reflect on the fact that the countries displaying the best economic performance in the world today are those countries with strong currencies.

If you look over the record of the past two or three years I think you will agree that the Bank of Canada has not taken an extreme view of the need to resist exchange rate depreciation or of the need to maintain wide interest rate spreads against the United States. On the contrary we have already had a very substantial downward adjustment in the exchange value of the Canadian dollar, most of which had become necessary owing mainly to the relatively high rate of inflation experienced in Canada earlier in the decade as compared with countries like the United States.

I turn now from the external aspect of our economic situation that makes us highly vulnerable to a further worsening of inflation to the internal aspect. As I have said, the Bank of Canada has had both very much in mind in its recent conduct of monetary policy.

The year-on-year rate of increase in the Consumer Price Index in Canada has now reached 9.6 per cent even with a lull in the steeply rising trend of food prices. We still have to face up to the need to bring domestic energy prices much closer to world levels and for some time wage settlements have clearly been on the rise again. While in recent months we have certainly been experiencing strong upward pressure on our price level from external sources, this is by no means the whole story.

I have noted that an important factor in our economic situation is the fact that many of our industries are operating uncomfortably close to capacity. In present circumstances we are much closer than is generally recognized to a situation in which most firms and industries, because they can readily sell just about all they can produce on a profitable basis, see little risk in incurring large cost increases or in posting large price increases. I am aware of the possibility that these demand pressures on capacity may begin to moderate over the period ahead and that, as markets become more competitive, firms will be under greater pressure to hold down their costs and prices. But in some degree this is precisely what has to happen if inflation is to be checked -- and it has not happened yet.

The inflationary potential in the present situation is greatly increased by the fact that Canadians have become highly sensitized to fears or expectations that inflation cannot or will not be held in check for long and is therefore bound to get worse. The danger is that these inflationary expectations will be reflected in the price and wage behaviour of Canadians and thus will turn out to be self-fulfilling. This would give us the worst of both worlds -- rising unemployment caused by rising inflation.

There are of course other aspects of our internal economic situation that have an important bearing on our current and prospective rate of inflation. There is the special problem of energy prices but on the other hand there is also the prospect that some slowing of the near-term pace of economic activity in the United States -- and to a lesser extent in Canada -- will moderate somewhat the recent degree of inflationary pressure. But with due allowance for all the possibilities there does not seem to me to be any justification for public policy to take any risks on the side of inflation in the foreseeable future.

This view seems to me to be confirmed by what is going on in the area for which I carry direct responsibility, namely, in the field of money and credit. The growth of money and credit in Canada has been remarkably strong and persistent for more than a year and would no doubt have been even more rapid had it not been for the steep rise in interest rates during this period. The trend rate of increase of the money supply on the narrow definition, currency and demand deposits (or M1), has averaged

about 9 per cent a year since mid-1978 as compared with the Bank's target range of 6 to 10 per cent. Broader measures of the money supply have been increasing at higher rates both in absolute terms and by comparison with their rates of growth through much of last year. So far this year the chartered banks' general loans have risen at an average annual rate of around 25 per cent, with the business loan component rising even faster. While at the time balance of payments considerations played an important role in the successive increases in the Bank Rate since the spring of 1978, it has now become clear from subsequent experience that a substantial rise in interest rates was also needed in order to contain the rapidly expanding demand for money and credit in the domestic economy.

To sum up, it is my view that the actions taken by the Bank of Canada constitute a reasonable and prudent response to the potential inflationary damage that would be inflicted on the Canadian economy by a failure to resist both further exchange depreciation and the continued rapid expansion of money and credit.

This brings me to the end of what I have to say in explanation of the Bank's recent monetary policy but before I conclude I would like to deal with a number of matters related to our actions that seem to puzzle many people.

First, as I have become very much aware, it is not generally understood that when money and credit are in strong demand there are no

means open to the Bank of Canada within its existing powers to limit their expansion which do not involve at least a temporary rise in interest rates. This is because a slower expansion of the supply of money and credit in these circumstances will not of itself do anything to produce a correspondingly slower growth in the demand for money and credit; interest rates must therefore adjust to higher levels to bring the demand down into balance with the reduced supply. The sequence in which these adjustments occur -- whether the central bank restrains the growth of money and credit with the consequence that interest rates rise or brings about a rise in interest rates with the consequence that the growth of money and credit slows -- can run either way. It is necessary, however, to recognize that these two developments are inextricably linked.

This still leaves the question -- could a way not be devised for controlling the expansion of money and credit which did not involve higher interest rates? As is true for all goods and services, the main alternative to allocating credit by price (interest is the price of credit) is some form of direct controls. Such a system would require detailed decisions as to which classes of borrowers should be able to obtain funds from which financial institutions and for what purposes and in what amounts. Measures would also have to be taken to ensure compliance. Moreover, steps would have to be taken to make sure that savers and investors did not divert funds to foreign markets to earn a better return and this would involve a comprehensive system of foreign exchange controls. Direct

controls on consumer credit and exchange controls have been used on occasion in Canada, mainly during World War II, but experience with such controls has led Canadian governments to avoid them if possible and, for my part, I would be opposed to proposals to use them in current circumstances. A major problem with direct credit controls is that they would not help to ensure an adequate inflow of capital into Canada, which requires sufficiently high interest rates to attract the needed funds; indeed, because such controls would require restrictions on capital outflows, they might well have the effect of discouraging capital inflows.

Another question that frequently arises is how can a rise in interest rates help bring down the rate of inflation when the higher rates themselves obviously add to the costs of doing business? The answer is that this effect is only part of the total effect of a rise in interest rates on costs and prices in Canada and by no means the most important part. A rise in interest rates discourages borrowing and spending. This brake on spending causes markets for goods and services to be less buoyant and more competitive than they would otherwise be with the result that businesses find it more difficult to raise their prices. The rise in interest rates thus increases the pressure on business to hold down its other costs of production, including labour costs, as well as its profit margins and prices. These same influences should also operate in turn in the direction of causing employees to moderate their demands for higher money incomes. In addition, the rise in interest rates helps to maintain the foreign exchange value of the Canadian dollar and it therefore helps to protect business firms and others from the higher

prices and costs of internationally-traded goods that would result from a lower exchange rate. It is because of all of these influences that one must look beyond the immediate impact of higher interest rates on business costs to understand their restraining effect on the rate of inflation.

I want to conclude my remarks by reminding you that our main job at the Bank of Canada is to exercise control over the quantity of money and credit supplied to the Canadian economy through the operations of our banking system. The performance of this monetary control function sometimes involves courses of action which are neither easy nor pleasant. That is certainly the situation we have been faced with in recent months. However, Parliament did not establish the Bank of Canada with the expectation that it would avoid unpopular decisions. The Bank was given a considerable measure of independence so that it would not succumb to the pressures of the moment but would rather be guided by the longer-term interests of the economic life of the nation.

Mr. Chairman, we are at a crucial stage in the fight against inflation. I think it can be said that we have reached a crisis of credibility in this matter. Do we continue the battle or do we forget about it for a time because we fear a period of slower economic growth? If we continue the battle we must be prepared to do those things that are necessary to restore the faith of people in the future value of our money. That can be done if we have the will to do it. That path will not at times be easy, but I assure you with confidence that it will not be nearly as unpleasant a path

as we shall quite soon find ourselves traversing if we decide to try to opt out of the battle against inflation. If we stay with it we have a very good prospect of emerging from a period of slow growth with a solid basis established for an efficient non-inflationary, highly competitive economy -- with high employment and a strengthening external position. These are the conditions that will allow interest rates to be considerably lower than they are now. These are the objectives that the Bank of Canada is pursuing in its area of responsibility.

NOT FOR PUBLICATION BEFORE: 8:00 P.M. MOUNTAIN STANDARD TIME
10:00 P.M. EASTERN STANDARD TIME

THE FIGHT AGAINST INFLATION

REMARKS BY R.W. LAWSON
SENIOR DEPUTY GOVERNOR OF THE BANK OF CANADA
TO THE FINANCIAL EXECUTIVES INSTITUTE OF ALBERTA
IN CALGARY ON NOVEMBER 20, 1979

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I am going to talk tonight about the fight against inflation. I had thought at one stage of giving my remarks the title "The War Against Inflation" but I finally decided against it. A war sounds more dramatic than a fight, and I don't want to add any drama to the current scene for there is enough of that already. Besides, anyone who doesn't know that a world-wide war against inflation is underway is not paying much attention.

The fight against inflation has indeed many of the characteristics of a war. For one thing, it is not a single battle but a series of battles; some battles may be won and some lost but the war goes on. Like a major war it seems likely to go on for years for no quick victory is in sight. As in a major war the whole community is involved; the war cannot be won by leaving it to some group of professional inflation fighters. The questions of strategy and of tactics are, I think, as difficult as those of war. And -- most important of all -- a successful outcome will depend, as it usually does in war, on the will and the resolution with which the struggle is waged.

I am not going to talk tonight about why we must wage the fight against inflation because I believe that you are already convinced that we must. It used to be popular in some circles even as recently as a decade ago to wonder aloud whether public policy would not be better advised to concentrate on learning how to live with inflation rather than on how to avoid it. But one hardly ever hears that said nowadays. It has now become apparent to virtually everybody that inflation is a disease that is too virulent and too socially divisive to temporize with. It did not seem to be so virulent in the days when people still had a firm faith in the future value of money, when they still believed that their governments and central banks would not permit any appreciable inflation for any appreciable time. That faith gave societies a good deal of natural resistance to the inflationary process. But those days are gone -- I hope not forever, but certainly for the time being. We live now in a world that is deeply skeptical about the future value of money. For that reason our societies are much more vulnerable to inflation than they used to be. For that reason it has become very dangerous to run risks on the inflationary side.

The fact that our societies have to cope at the same time with some big changes in the relative prices of some commodities, notably petroleum, increases the problem. In order to absorb these price shocks without a major set-back in the fight against inflation it is necessary that the defences against inflation in all other areas of the battlefield be strengthened. If they are made strong enough the price shocks can be accommodated without major damage

to the value of money. This is what has happened and is happening in some countries, for example, Germany and Switzerland. This is what we in Canada should try to do. Good anti-inflationary policy can accommodate relative price changes, and it is not very good policy if it cannot.

The question then is not whether we should fight inflation but how to fight it. You have, I hope, some familiarity with what we in the Bank of Canada believe to be our responsibility in this matter. Our view has been presented on many occasions over the last few years in Annual Reports and in speeches, and it was presented again in a statement made by the Governor of the Bank to the House of Commons Standing Committee on Finance, Trade and Economic Affairs in Ottawa on October 25. (Copies of that statement are available at Bank of Canada Agencies or by writing to the Secretary, the Bank of Canada, Ottawa.)

The Bank of Canada's policy is summarized in that statement in these words:

> "For some time now the Bank of Canada has been trying to improve prospects for the functioning of the Canadian economy in the years ahead by following a monetary policy directed towards resisting any acceleration of inflation and encouraging its gradual reduction. That policy has meant resisting inflation coming from external sources through our international trade and our foreign exchange rate as well as inflation generated or accommodated internally by the growth of money and credit".

I am not going to attempt to summarize the rest of that statement but I shall rather come at the same range of matters indirectly by commenting on some of the criticisms that I have heard or read of the Bank's actions in pursuit of its policy. The criticisms virtually all begin with "Yes, I'm also against inflation, but --". I want to talk about these "buts". They are nearly all variations on the theme that the current level of interest rates in Canada is unnecessarily high.

Before I proceed to comment on these criticisms I want to acknowledge that the current level of interest rates is indeed bitter medicine. I am very sorry that it is so bitter. It is perhaps most bitter to people who are committed to borrowing programs that they would not have undertaken if they had thought that interest rates would rise to present levels. Some of those people are undoubtedly suffering great hardship and they feel that they have been badly treated. They join the group of innocent victims of an inflationary society. One of the worst features of inflation is the injustices it causes. The further that it proceeds before it is fought effectively the greater will these injustices be. That is why the medicine, though bitter, is necessary.

* * *

A number of people seem to think that there is, or should be, a better way of fighting inflation than by permitting interest rates to rise.

Prominent among the advocates of a "better way" are some economic commentators who say in almost so many words that they do not know a "better

way" of fighting inflation but that somebody should discover one. There is realism in that criticism in that the critics recognize that they don't know a "better way", but there is wishful thinking in their hope of one being discovered. I am not optimistic about somebody finding a better way, and would say to you "Don't hold your breath". I therefore think that we would be well advised to address ourselves to doing the best we can with what we know.

* * *

Quite a few people are uneasy about the use of increases in interest rates to contain inflation because it is a non-selective technique -- it rains alike on the just and the unjust. They wonder if it would not be better to distribute credit on the basis of social need rather than of interest rates, keeping interest rates low to approved borrowers. Would not that be a "better way"?

These critics are in principle questioning the merits of the price system as a technique of distribution, and they presumably have the same uneasiness about distributing beef or shoes or houses by the price system. The case for the price system is not that it is perfect but rather that it is better than the alternatives. The main alternative to allocating credit by the price system is some form of direct credit controls. If such controls were to be relied on to an appreciable extent they would involve detailed decisions as to which classes of borrowers should be able to obtain funds, from which financial institutions, for what purposes and in what amounts. If such controls were to achieve an allocation of credit much different from that with a price system they would have to be supported by a fairly comprehensive system of foreign

exchange control to prevent end-runs of them through foreign financial markets.

As a practical matter comprehensive direct credit controls could not have much effect unless they were tightly administered and firmly enforced, and this would require a large administrative staff and masses of reporting forms. Moreover, the sheer magnitude of the administrative job makes it impossible for comprehensive controls to be sensitive to the special circumstances of individuals or of small businesses. It is perhaps for these reasons that those who are attracted to the theoretical selectivity of direct controls are a bit reluctant to spell out in detail what would be involved.

There is another real problem with direct credit controls in the present situation. Because Canada is running a current account deficit of some 7 billion dollars a year in its balance of international transactions and because that deficit cannot be reduced quickly we are very dependent for the time being on inflows of foreign capital to finance it. Direct credit controls imposed by Canada could not force foreigners to lend money to Canadians. They could not therefore deal with the external aspect of our inflation problem.

* * *

I should perhaps note here that there is another version of the direct controls approach that concentrates on incomes, that is, price and wage controls. Ideas for income controls are always emerging; some are for a period, some are for the indefinite future, some are partial, some are comprehensive. I do not want to express a view on the merits of temporary price and wage controls because I think that the merits vary with the circumstances. But I would like to

make a comment on proposals for continuing price and wage controls, whatever their particular form. The main idea behind the advocacy of continuing incomes controls is that inflation is a cost-push phenomenon, that the distribution of economic power in our society is now such that our markets for labour and for goods will generate strongly rising costs and prices at any tolerable level of total demand unless they are constrained by government controls. If this is true it is a depressing proposition because it portends a more regulated economy, with less room for individual incentive, initiative and choice. I don't think that it is true. I think that our markets will work tolerably well if they are given a chance. They have worked quite well, without generating an inflationary bias, for considerable periods in the past. Why can they not do so again? If in the future they don't work well enough in one area or another it would be better economic policy, in my opinion, to try to find out how to get them to work acceptably without direct controls than to try to apply direct controls to them.

* * *

Some advocates of a "better way" of fighting inflation than by permitting interest rates to rise say that the Bank of Canada has missed the point -- it should be restraining monetary expansion rather than letting interest rates rise. These people have failed to recognize that in our circumstances the inevitable result of a lower rate of monetary expansion is higher interest rates. And vice versa. The two are different aspects of the same process. It would be quite correct to say that what the Bank of Canada has really done in recent weeks is to restrain the rate of monetary expansion in Canada. It has therefore done what this group of critics want.

When described in these terms the recent increases in interest rates can be regarded as caused by the continuing high demand for money working against the lower rate of monetary expansion.

* * *

Another rather popular view is "Yes, I'm against inflation but I don't want to see anything done that will weaken the prospects for employment and growth this winter. The United States seems to be headed for at least a mild recession. Why would we now do anything in Canada that would reinforce a U.S. recession in restraining the growth of demand in Canada in the months immediately ahead?"

The answer to that is that what happens in the next few years is even more important than what happens in the next few months. If we temporize with inflation now people will conclude that there is an absence of will to resist it and that it will get worse. The credibility of governments and central banks is not sufficient to prevent that for, as I have said, the public has learned to be skeptical about them as inflation fighters. So, if Canada were to decide today to rest on its oars in the fight against inflation in the hope of some short-term benefit, people's expectations of rising inflation would be strengthened and their actions would be influenced in ways that would tend to validate those expectations. It would not be long before the problem of inflation in Canada would be a good deal worse than it now is, and our economic prospects would worsen correspondingly.

As an example of how things would develop if Canada were to retreat from the battle against inflation, consider what would happen in the foreign

exchange market. With lower interest rates in Canada than in the United States there would be an interest rate incentive for both Canadians and foreigners to hold U.S. dollars rather than Canadian dollars, and this would come at a time when Canada still had a large international deficit on current account to finance. These circumstances would put heavy downward pressure on the external value of the Canadian dollar. But that is not all. The downward pressure would be greatly increased by market expectations. The evidence of weakness of will in Canada to check inflation would be contrasted with the evidence of renewed determination in the United States and would lead people to expect yet a further considerable decline in the Canadian dollar in the future. The market would discount that expectation to the present, adding momentum to the near-term fall in the exchange rate. I do not know how one can tell how far the Canadian dollar would fall, but it would certainly fall far enough to generate a strong acceleration of the inflation of costs and prices in Canada. Our economic problems would quickly become much more difficult to deal with than they now are.

I have thus no reservations about saying to you that, in the environment that exists, Canada's economic situation and prospects are much better with the interest rate levels that we now have than they would have been if the increase in interest rates in recent months had not occurred.

Some people seem to think that the Bank of Canada has, or should have, an econometric model of the Canadian economy that would give all sorts of quantitative detail to support this view. They seem to imply that the Bank

is hiding the results of that model. I want to say to these people that their view rests on a misunderstanding about both the general nature of econometric models and about the ability of such models to cope with situations like this one where rapid change in expectations are paramount.

Econometric models are valuable aids to economic analysis but they have limitations which must be recognized. The apparent precision of their detailed print-outs is a misleading indicator of their reliability because their forecasting quality depends crucially upon the degree to which future economic responses turn out to be the same as those deduced as typical from the record of the past and built into the model. This limitation is particularly serious when it is clear that people's economic decisions will be much influenced by their expectations about the future course of public policy because there will usually have been little relevant past experience to build into the model. The econometric models available to us and to others do not cope at all well with situations where such expectations play a major role.

* * *

Another view of rising interest rates is that they are themselves inflationary because they add to the cost of doing business and to the cost of living, and therefore they exacerbate rather than mitigate inflation. Whenever I hear this argument I think of the story that we all learned at school about the blind men examining the elephant. You will remember that the impressions of each were partly right but mainly wrong. So it is here. An increase in

interest rates does add to costs but its other effects are much greater and they are anti-inflationary. Rising interest rates tend to restrain spending and thereby to make markets less buoyant. They encourage a climate in which it is harder for both businesses and workers to increase the prices of their services. In present circumstances they also give support to the foreign exchange value of the Canadian dollar and thus moderate the increase in prices of goods that are internationally traded. There is no doubt whatsoever that the net impact of rising interest rates on a market economy is anti-inflationary.

* * *

Another view on the current situation is that the effect of rising interest rates in supporting the foreign exchange value of the Canadian dollar, while admittedly anti-inflationary, is nevertheless undesirable because it stands in the way of encouraging a reduction in Canada's external trade deficit through further exchange rate depreciation. The trouble with this reasoning is that the essential pre-conditions for it to work well are not satisfied in the present situation. These pre-conditions are that there be appreciable unemployed resources able to move quickly and effectively into producing internationally-traded goods if the price is right. That is not the case in Canada today. There is in Canada today relatively little unused industrial capacity capable of producing internationally-traded goods reasonably efficiently. In these circumstances further exchange rate depreciation will give us more inflation without much compensation in the form of strengthening our international payments position.

This idea that there is in Canada today relatively little unemployed capacity in place in the industries that produce internationally-traded goods may not be as surprising to you who are familiar with the tautness of the economic system in Western Canada as it seems to be to many other Canadians. They have heard so much about high unemployment in Canada that they have missed the fact that Canada's ability to produce more exports or more goods to replace imports is severely constrained by capacity bottlenecks all over the place. In time these capacity bottlenecks will be eased by new investment in plant and equipment, and that process is underway, but it takes quite a while for new capacity to be put into place and to start producing. I do not believe that the current level of interest rates will prove to be a serious deterrent to new investment in plant and equipment in places where the investment is really economic. In due course one can expect to see the movement of unemployed workers in other industries into the expanding industries, but that too will take time.

* * *

Yet another view about current interest rates is that they are indecently, perhaps even immorally, high.

If the argument is that one wouldn't have interest rates like ours in a well-run society I am in complete agreement, but one wouldn't have inflation rates in the near-double-digit area either. The basic fact is that our high interest rates are a direct reflection of our high inflation rates. I think that most lenders and borrowers are quite well aware of that.

Whether current interest rates are now too high relative to the rate of inflation is another matter. For purposes of economic decisions what mainly matters is the comparison of actual interest rates with participants' views of future inflation rates. If borrowers think that interest rates are high in that sense they will try to postpone their spending plans; if they think they are low they will try to advance their spending plans. You only have to look at the enormously high volume of borrowing in Canada in recent months to see that Canadians have acted as if they regarded interest rates as low relative to their expectations of future inflation. If they change their minds about that it will reduce the demand for credit, and that is one of the things needed to open the way for interest rates to fall.

Perhaps I should add here a word about the international aspect of this matter. It seems to me that foreign lenders, like Canadian borrowers, have been acting as if they regarded interest rates in Canada as not being high relative to their expectations of the future rate of inflation in Canada. If foreign lenders were firmly of the opposite view I believe that the Canadian dollar would be stronger in the exchange market than it is.

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Let me conclude with one more view about current interest rates, and this time one with which I agree and that will therefore allow me to end on a harmonious note. That view is that inflation should not be fought only with monetary policy. I don't intend to dwell much on the various initiatives

that could usefully supplement interest rates in the fight against inflation, not because they are unimportant but because they are primarily other people's business. But let me mention some of the things that would help.

One thing that would help is a reduction of the fiscal deficits of governments. I am not opposed to fiscal deficits in principle -- there are circumstances when they are defensible -- but to have enormous cash deficits even when much the greater part of the economy is operating close to its physical capacity is very hard to reconcile with any principles of non-inflationary government finance. Moreover, the size of government deficits has certainly contributed to the public expectation of continuing rapid inflation both in this country and in others. It will, I think, not be possible to restore people's confidence in the future value of money without giving them grounds for confidence that governments at all levels will act with prudence and restraint in budgetary matters.

Another thing that would help would be confirmation of reports that there is a great deal more natural gas that could be made available at economic prices in this province than has been generally supposed. If in fact there is enough, as I have been told there is, to meet Canada's requirements and also to export very large amounts indeed to the United States, I would regard that as very good news in the anti-inflationary fight. It would ease considerably the tight constraint that we in Canada now suffer by virtue of our exposed external financial situation. It would give some room to manoeuvre that we in the Bank of Canada would very much like to have.

To speak more generally of policies other than monetary policy in the fight against inflation, the way to make an economy less inflationary is to make it more flexible, more able to adapt to changing circumstances. A more flexible economy can run at a higher level of employment and output, and a lower level of unemployment, without overheating. There are in our economy many practices of governments, businesses and labour that reduce the flexibility of the economy, and that therefore lower the level of employment at which it begins to generate inflationary cost and price trends. Perhaps the major single error in economic analysis in this country in the last decade or two has been to under-estimate the growth and importance of these practices and the extent to which they have raised the minimum level of recorded unemployment at which our economy can operate without generating inflation. To the extent that these practices are not justified on their merits we should get rid of them. To the extent that they are so justified we must be prepared to accept the lower level of output and employment that they make necessary.

This is the idea on which I want to stop. We in the Bank of Canada must run monetary policy within the economy as it exists. We shall continue to move gradually towards a non-inflationary rate of monetary expansion because that is in the interests of the economic life of the nation, a goal we are required by Act of Parliament to pursue. How smoothly the economy will respond over time to a declining rate of monetary expansion is yet to be seen. If it responds flexibly -- if people's expectations of future inflation decline -- the upward trend of costs and prices will moderate rapidly enough on average to permit

the maintenance of relatively high levels of employment and output. To the extent, however, that the economy responds inflexibly and that the upward trend of prices and costs is stubborn, then employment and output will be squeezed. This is the kind of thing that is involved in fighting inflation. The more clearly we all recognize it the better will be our chances of carrying on the fight intelligently and with the minimum of confusion and suffering.

NOT FOR PUBLICATION BEFORE: 1:30 P.M. IN WINNIPEG 2:30 P.M. IN OTTAWA
APRIL 8TH, 1980

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE CANADIAN CLUB OF WINNIPEG
WINNIPEG, MANITOBA
APRIL 8TH, 1980

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to
The Canadian Club of Winnipeg
April 8th, 1980

Each year my Annual Report to the Minister of Finance is published about the third week in March. Since that report is mainly devoted to an up-to-date account of the monetary policy that the Bank has been following, I do not usually feel the need to comment further on the subject for some time. However, this year is different. A great deal has been happening on the monetary scene since my report was written in the latter part of February and I am glad to have this opportunity to explain what we have been doing in recent weeks. But to provide a background to these most recent developments I will begin by summarizing briefly the main themes of my Annual Report.

In 1979 there was a marked intensification of inflationary pressures on the Canadian economy. In part these pressures were of external origin. Inflation was on the rise in most of the world's main trading countries, and the rise was very pronounced in the United States. This had extremely unsettling effects on expectations -- as evidenced in no uncertain terms in world markets for precious metals and other commodities -- and it spilled over into Canada through our foreign trade,

notably through a 15 per cent annual rate of increase in the costs of the goods we import. We could not do much about other countries' domestic inflation, but we tried to guard against allowing a further substantial decline in the external value of the Canadian dollar since that would magnify the effect of rising prices abroad on our own cost and price performance.

In part the increase in inflationary pressures in Canada in 1979 was of domestic origin. The domestic economy was hard pressed to keep up with the demands for goods and services that were being placed upon it. Unusually high operating rates in relation to existing capacity were characteristic of a broad range of our industries. Total employment in Canada grew very rapidly indeed across all segments of the labour force and labour markets tightened in most parts of the country, above all for skilled workers. These conditions greatly weakened any effective resistance to the spread of cost and price increases across markets and across industries; indeed, they added to the inflationary pressures coming from external developments.

In this climate, the Bank came to the view in the second half of 1979 that there was no responsible alternative to sizeable increases in short-term interest rates in Canada. The monetary aggregate on which the Bank puts the primary emphasis, currency and chartered bank demand deposits or M1, was growing vigorously after a brief pause early in the year. Credit demand was persistently very strong throughout 1979, as

were the rates of expansion of the broader monetary aggregates. The concern generated by these signs of the strength of demand for money and credit was strongly reinforced by the downward pressure exerted on the Canadian dollar by the sharp increases in U.S. short-term interest rates that began in July. In these circumstances the need for higher short-term interest rates in Canada was very obvious. Not to have acted, and acted promptly, would have meant running a serious risk of further worsening an already dangerously inflationary situation. At the same time we were concerned that the rise in Canadian interest rates be no sharper than required. In the event, short-term interest rates rose somewhat less in Canada during this period than corresponding rates in the United States, and traditional interest differentials between similar instruments in the two countries narrowed or disappeared completely.

All this is spelled out in my Annual Report. But even as that report was being finished in the latter part of February it was apparent that the somewhat steadier conditions that had emerged in U.S. financial markets around the end of 1979 had come to an end. The astonishing sequence of interest rate increases in the United States that we have witnessed in recent weeks got underway in some areas of the market well before the second half of February. Bond yields in the United States rose steeply through January and most of February and here in Canada the bond market moved in much the same way. Except in financial markets these

developments did not seem to attract much attention in Canada, perhaps because they involved no press releases, no announcements of Bank Rate or prime rate increases. It is clear, however, that they were of cardinal significance, representing a fundamental shift of attitudes about economic prospects.

The drastic rise in U. S. bond rates was a direct reflection of rapidly spreading pessimism in that country about the prospects for any early relief from steadily worsening inflation. A troubled international situation, the prospect of increased defence outlays and larger budget deficits, an economy that in any case seemed virtually impervious to the measures of financial restraint already taken the year before -- all these factors combined to strengthen the view that longer-term interest rates were simply too low to be realistic in relation to what lay ahead. Strongly held fears and expectations of higher inflation to come already appeared to characterize the behaviour of U. S. consumers. They had for some time sharply curtailed their willingness to accumulate new financial savings in the face of inflation rates that outstripped the return they could hope to get on their savings and that made it a good bet to buy earlier rather than later. It might be added that the increasingly widespread vogue of multiplying one month's price increase by twelve to get an annual inflation rate has not helped matters. On this basis, the exaggerated notion that the basic trend of U. S. inflation has gone up to almost 20 per cent a year has unfortunately gained widespread currency.

Since mid-February U. S. short-term interest rates have again risen explosively. The spiral started on February 15th with an increase in the discount rate of the Federal Reserve System from 12 per cent to 13 per cent. By February 19th major U. S. banks had raised their prime rates from 15 1/4 to 15 3/4 per cent. But that was just the beginning. Increase followed increase in short order: on February 22nd to 16 1/4 per cent; on February 29th to 16 3/4 per cent; on March 3rd to 17 1/4 per cent; on March 7th to 17 3/4 per cent; and on March 13th to 18 1/4 per cent. On March 14th the U. S. Administration and the Federal Reserve introduced a set of additional fiscal and credit measures designed to offer increased resistance to inflation. The fiscal measures were mainly aimed at eliminating the budget deficit while the package of controls on credit and other financial transactions was chiefly directed towards reining in consumer spending and speculation financed by credit. On March 18th, with financial markets coming under continued pressure, the prime rate moved up to 19 per cent. On March 28th it moved to 19 1/2 per cent and on April 2nd to 20 per cent. At that point it had jumped by almost 5 percentage points in six weeks.

At bottom, this chain of developments was the result of a widespread erosion of confidence in the future value of money which resulted in vastly increased uncertainty in U. S. financial markets. Since no one could be sure how strong the inflation psychology had become no one could be sure how high interest rates would go.

Some Canadians are tempted to sit back and regard the situation in the United States with some detachment. After all, they say, has not our recent consumer price performance been distinctly better than theirs? The fact of the matter is that this impression of inflation in Canada being less severe than in the United States is more apparent than real; there is not much in it when account is taken of the much greater extent to which the United States has adjusted to higher energy prices and of certain peculiarities in the treatment of housing costs in the U.S. consumer price index. Furthermore, neither industry price nor labour cost statistics suggest that Canada's trend rate of inflation might be below that of the United States. Surely no one would assert that our public sector finances or our balance of payments position are in better shape. If our performance in controlling inflation was believed by investors to be much better than that of the United States, the Canadian dollar would be much stronger than it is.

I now want to address in some detail the market situation faced by the Bank of Canada at the beginning of March. For some time previously we had been getting by with short-term interest rates that were no higher and quite often lower than those in the United States. For example, the prime loan rate of the Canadian banks had been 15 per cent since October -- whereas the prime rate of American banks had risen to 15 1/4 per cent by mid-February and to almost 17 per cent towards

the end of that month. But the Canadian dollar had nevertheless shown unusual strength in exchange markets for a number of weeks up until early March partly because of an unusually favourable trade performance but also because of a strong inflow of capital related to investment in our resource industries. This was apparently due in large measure to the enhanced prospects for major oil discoveries off Newfoundland. How long this inflow would continue and how strong it would be was of course completely unpredictable. What was sure was that it would vary with rumours and progress reports on drilling by the oil companies concerned.

To those uncertainties were added others. It had been indicated in advance that fiscal and credit measures aimed at redressing the situation in the United States would be introduced before long, but one did not know the precise timing of these measures, their nature, or what impact they might have on financial markets. The foreign exchange market in particular was being affected by these uncertainties. Indeed, it seemed impossible to pick a Bank Rate that could be counted on to be appropriate in relation to foreign exchange and money market conditions for more than a very short period.

In this extraordinarily fluid situation the Bank of Canada came to the view that it needed to be able to react to developments more quickly, and with more flexibility, than was possible with a fixed Bank Rate

system. To set a Bank Rate that we could at least have hoped would remain unchanged for some weeks would have meant fixing it very much higher. On Monday, March 10th, the Bank of Canada announced that the Bank Rate would be allowed to float, that is, that it would be set each week at 1/4 percentage point above the latest average rate established in the weekly auction of 91-day Treasury Bills issued by the Government of Canada. This new system went into effect on March 13th when the next Treasury Bill auction was held.

The advantages of having a floating Bank Rate in periods like the one we have been passing through recently were demonstrated rather clearly in the first week of the new system's operation. On the basis of the results of the Treasury Bill auction on March 13th the Bank Rate moved up slightly from its earlier fixed level. But barely more than an hour after the bids were submitted a major U.S. bank announced a further 1/2 percentage point increase in its prime rate to 18 1/4 per cent and during the next day this new higher level became general. In the face of the associated rise in U.S. money market rates the exchange value of the Canadian dollar began to weaken, particularly at the start of business on Monday, March 17th. With the flexibility of a floating Bank Rate it was possible for the Bank to permit a prompt rise in Canadian money market rates, including the Treasury Bill rate, to stem the downward pressure on the Canadian dollar. Under the previous fixed Bank Rate regime

this change could not have been effected so promptly nor so flexibly since it would have implied a decision to move to a new, higher Bank Rate that could be expected to remain in effect for at least a few weeks.

Although the move to the floating system has been regarded by some people as an effort on the part of the central bank to minimize its share of responsibility for the level and movement of short-term interest rates, the fact of the matter is that the Bank of Canada acknowledges every bit as much responsibility for short-term interest rates under this new system as under the former one. This was stressed in the press statement accompanying the announcement of the new system. What we do not answer for is the state of the world. A prime rate of 20 per cent in the United States was not brought about by the Bank of Canada and it is not our responsibility. We do, however, accept full responsibility for the way in which we are trying to cope with the problems that confront this country in the world as it is these days.

The particular way in which the Bank Rate is set is not an important factor in our present difficulties. Our real and immediate problem is not one of technique. It is that short-term interest rates in the United States have risen far above ours. Sometimes it is charged that Canadian monetary policy is made in Washington. It is not. But Canada has not severed its connections with the outside world either, and if U.S. interest rates rise to extremely high levels there is no point in

pretending that we remain unaffected in any way. There are no restrictions on the flow of funds across our border. If interest rates in the United States are so much higher than ours that funds are attracted or diverted from Canada the result will be downward pressure on the exchange value of the Canadian dollar. The lower the Canadian dollar, the higher will be our import costs, over and above the rise in these costs due to soaring prices in the United States. This, while unwelcome, is only part of the real danger. The real danger, one that it would be folly to ignore in present conditions, is that strong additional price pressures from this source would have a pervasive and cumulative impact on inflationary expectations and on wage and price behaviour in Canada. They would give fresh impetus to the inflationary spiral. Instead of merely trading off a lower Canadian dollar in exchange for lower interest rates, we would quickly find ourselves faced with more rapid exchange rate depreciation, more rapid inflation, and before long with even higher interest rates; in short, our economic problems would quickly get worse. To believe otherwise is merely wishful thinking.

I know the argument that the risk of higher inflation from a lower Canadian dollar is a risk that has to be taken in the interests of improving the competitive position of Canadian industry. However, by any reasonable standard most of our industries are already in a strong competitive position internationally. As discussed in detail in my Annual Report, the actual situation of Canadian industry is much more

clearly one of needing additional capacity to produce than one of needing more exchange depreciation to enhance its price and cost competitiveness. Thus any potential benefit to our balance of payments from a lower Canadian dollar would likely be at best small and delayed. By the same token its impact on our domestic prices and costs would be correspondingly large and quickly felt.

The Bank of Canada is aware that sharp increases in interest rates are painful to many Canadians, including mortgage borrowers, farmers and small businesses. It is also aware, of course, that interest rates which are not high enough to compensate for inflation are painful to the even larger number of Canadians whose savings provide the funds for borrowers to spend. The Bank has been trying to steer a course through an extraordinary and highly unpredictable situation in a manner that is designed to minimize the increases in interest rates required to curb inflation in Canada. We are not operating monetary policy on the basis of some preconceived view of the appropriate relationship of interest rates in Canada and the United States. We are aware that there are some other flows of funds that are not particularly sensitive to interest rates that may help us, in the same way as the strong inflow of capital related to the oil industry helped us up to a short time ago. We may see a resumption of that kind of inflow and other inflows as well. Foreign investors who take a long-run view of the Canadian economy, which

because of its energy and other resources looks to them like one of the most favoured places on earth, may provide some underlying support for the Canadian dollar so long as they retain confidence in the way we manage our affairs. Even in the present difficult period there has been evidence of investment by foreigners in long-term as well as short-term Government of Canada Canadian dollar bonds. Moreover, U.S. interest rates may not stay at such extremely high peak levels for long and this should give pause to those who are tempted to take a strong position against the Canadian dollar. These are some of the cross-currents in the troubled waters through which we must steer.

Within the possibilities available to the Bank of Canada in these difficult circumstances, I do not know of a better course than the one we are pursuing. I know that it is unpleasant, but I hope that Canadians will take some encouragement from the probability that the present extraordinary situation will be short-lived and from the fact that facing up to unpleasant decisions now is the road to lower inflation in Canada in the months to come.

I conclude my remarks by reminding you that it is inflation that poses the greatest threat to our society at the present time. Whatever problems each day brings we must never forget that. Because inflation is so harmful to the nation as a whole we must think of the welfare not only of particular groups of borrowers but of all 23 million Canadians.

THE INTERNATIONAL MONETARY SYSTEM: KEY ISSUES

Background Paper

for remarks by

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at the

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The International Monetary System -- Key Issues

INTRODUCTION

In examining the key issues facing the international monetary system as we begin the 1980s, it may be useful first to take some account of the nature of the major problems in the world economy today. The most basic of these problems stem more from real, that is to say physical, causes than from financial causes. The plight of the poorer countries of the world reflects to a large extent the scarcity of real resources relative to population in many areas. Even in the case of those difficulties generally attributed to the sharp rise in the price of oil in recent years the fundamental problem is a real not a financial one: the world is running short of readily accessible supplies of energy from conventional sources. Although it follows that these real resource problems cannot be solved merely by international arrangements for making payments and allocating credit, no matter how efficient they are, a well-functioning international monetary system can make an important contribution in coping with the financial aspects of these problems and thus facilitating the development and transfer of real resources.

Perhaps I should make it clear at the outset that I do not regard reform of the international monetary system as a key issue at this time. Even though the present set of international monetary arrangements can hardly be described as a complete and coherent system, particularly in the sense of one that includes uniform standards for the behaviour of all countries, I see no sign that we can expect much of a movement in that direction. Rather, any evolution of our present arrangements is more likely to be guided by pragmatism rather than by principle. In other words, the main task in the period immediately ahead will be to make what we have work as well as possible.

When the role of the international monetary system is discussed these days attention inevitably focusses on the huge payments imbalances that have arisen from the oil price increases and to some extent from high and varying rates of inflation around the world. The general thrust of this paper is to argue that the international monetary system -- or if we include the private as well as the official banking institutions, the international financial system -- can be expected by and large to function efficiently in recycling funds from surplus countries to those deficit countries that are credit-worthy or, possibly with the help of IMF programs, can be made credit-worthy, but this will not obviate the need for difficult real adjustments. There is a serious danger that in this process the developing countries of the world will

bear an especially heavy burden, with consequences not only for the ability of these countries to improve the lot of their people but also for the growth of the world economy.

I express confidence in the capacity of the international financial system to do its part in the job because I am not aware of serious deficiencies in the set of institutions that comprise the system. On the contrary, in recent years it has proven to be remarkably resilient and, although there are pitfalls that must be avoided, I believe it is capable of meeting the demands that in any reasonable view should be placed on it. How well it will perform its role is, nevertheless, a key issue.

Inflation, another very serious problem for the world economy, can be classified as stemming more from financial than from real causes, although recently the problem has been exacerbated by the oil price increases. For some, a key issue for the international monetary system is whether its institutional arrangements can make an important contribution towards controlling inflation by enforcing some degree of discipline on domestic financial policies. Here I believe the prospects of such external discipline having a marked impact are rather limited and that it will be necessary to look mainly to the political will of individual countries to follow appropriate economic policies if inflation is to be controlled.

It may be useful to begin a discussion of the international monetary system with a brief outline of how it has evolved over the last decade or so. I will then go on to discuss the role of banks and financial markets in international lending, touching on the particular problems facing many non-oil developing countries at the present time, and other potential problems in this area. Finally I would like to focus on the interrelated problems of oil price increases and inflation.

RECENT EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM

The evolution of the international monetary system since the late 1960s has to only a limited extent reflected deliberately planned changes in the institutional framework; much more pervasive have been the changes that have come about as a result of the pressure of economic forces. For example, it was primarily the wide disparities in economic performance, especially in regard to inflation, among countries who in many cases failed to make appropriate or timely exchange rate adjustments that led to the breakdown in the early 1970s of the Bretton Woods exchange rate system and gave rise to the floating rate system we have today.

Exchange Rate System

The present exchange rate system is clearly much more flexible than the par value system which prevailed for nearly three decades after the Second World War, but other than that it is not easily characterized. A large number of countries, in fact, still peg their currencies to the dollar,

to some other currency or to some composite basket of currencies such as the SDR, though this is much less significant than may appear on the surface as the currencies in which the bulk of world trade is conducted are not pegged. Even among those countries whose currencies are not pegged, there is a great variety of exchange arrangements. All members of the European Community other than the United Kingdom participate in the common margin arrangements of the European Monetary System but their currencies float jointly against those of other countries and occasionally currencies are realigned within the system. Certain countries adjust their exchange rates more or less frequently according to a set of indicators or a pre-announced crawling peg. The currencies of most of the others, including the United States, Canada, Japan and the United Kingdom, can be broadly characterized as floating independently.

All of the major trading countries manage their exchange rates to some degree. In recent years many have intervened quite heavily at times in their exchange markets and they have all used other policy instruments to influence their exchange rates. The reasons for this and for the fading away of debate over the merits of "clean" floating relate to actual experience under floating exchange rates.

The evidence of recent years demonstrates that, while the broad movement of floating exchange rates has been in the right direction, the system has tended to encourage too much movement rather than too little as was the case under the earlier pegged system. In practice,

exchange rate changes have not typically been gradual over time and, in the short run, they have not necessarily been consistent with divergent economic developments among countries; on the contrary, with the increasing internationalization of capital markets in particular, there has been a tendency for the exchange rates of major currencies to move not only very abruptly but also at times to over-react to changed perceptions of near-term prospects. Such movements can cause unnecessary disruption to the economies of the countries affected. This has led to a wide acceptance of the view that, while letting their exchange rates be influenced by underlying economic forces, monetary authorities need to give short-term exchange rate considerations some weight in their interest-rate strategy and to intervene at times in exchange markets.

A floating rate regime, initially viewed as a temporary expedient, was gradually accepted by the International Monetary Fund and by most of its major members. Concurrently other significant changes were made in the framework within which the Fund functions. Altogether these changes were basic in character and generally such as to meet the need to deal with the evolving realities of the international monetary system. The second amendment of the IMF Articles of Agreement which came into effect in 1978, therefore, involved much more than a formal recognition of a floating exchange rate system.

IMF Surveillance

The most significant of the 1978 amendments to the Articles of Agreement of the IMF was the revision of Article IV. Previously this

Article focussed primarily on the need for countries to promote exchange rate stability and to maintain orderly exchange arrangements. Under the new version, member countries may choose the exchange rate regime best suited to their circumstances. Emphasis is placed on the crucial importance of individual countries following economic and financial policies that contribute to sound economic growth and to a stable international monetary system. Accordingly, this Article provides for a broadening of the scope of Fund surveillance of individual countries' exchange arrangements and economic situations. In exercising this surveillance the Fund holds periodic consultations with member countries and, in evaluating their performance, considers in addition to their exchange rate policy their compliance with the more general obligations of Fund membership, in particular the appropriateness of their economic and financial policies in fostering growth with reasonable price stability.

An important purpose of this emphasis on more general considerations is to strengthen the influence that the Fund can exercise on the economic behaviour of all of its members. It has traditionally been much more difficult for the Fund to impress on surplus countries than on deficit countries the need to take corrective measures when this appears appropriate, since the main incentive that it could bring into play has been access to its lending facilities. Moreover, in a floating rate environment and with the increased role of international capital markets in providing balance of payments support, use of the Fund's lending

facilities that involved negotiation of a comprehensive adjustment program has not in many cases been sought as quickly as before by countries with weakening balance of payments positions. The Fund is continuing to work toward strengthening the effectiveness of its surveillance of the economic behaviour of all member countries. It is probably too much to expect, however, that the Fund will ever have as much influence over surplus countries or those with relatively easy access to alternative sources of funds as it has over those countries requiring its financial assistance.

A great deal of consultation about economic policies of the major industrial countries is also undertaken in a variety of other international forums such as the OECD, the EEC, the Bank for International Settlements and more recently Economic Summits. Within the Fund itself, regular meetings of the Interim Committee, the Development Committee and other groups have also provided opportunities for the discussion of broad economic orientations as well as the ongoing developments of the Fund's own policies and practices.

IMF Lending Facilities

The IMF has responded actively to the changing international environment in developing its lending facilities. In the early years of its existence, the concept that the Fund's resources should revolve over a short period dominated the Fund's policy. Drawings under the basic credit tranche facilities were normally made over one year and countries were

expected to repay the Fund within three to five years, though several countries had successive stand-by arrangements. In recent years the Fund has introduced greater flexibility in the use of credit tranches, including the possibility of stand-bys that on occasion could extend over periods of up to three years. It has also developed a number of new facilities in response to particular circumstances and to meet the general needs of member countries. The most noteworthy innovations have been the creation of the Extended Fund Facility in 1974, the setting up of the 1974 and 1975 Oil Facilities, the establishment of the Trust Fund financed with profits from the sale of Fund gold and the creation of a U.S. $10 billion Supplementary Financing Facility that became operational in early 1979. In addition, there was an increase in the quotas of members in 1978 and another is in process.

While guidelines are laid down for all drawings from the Fund, a major share of the borrowing in recent years has been under facilities that involve relatively light conditionality, that is to say, without strict performance criteria. The total amount of drawings under upper credit tranches, the Extended Fund Facility and the related Supplementary Financing Facility has been relatively small, although a notable increase is in prospect this year. Such drawings are conditional on the adoption of policies appropriate to restore a viable balance of payments position with the stringency of these policies depending on the magnitude of the disequilibrium.

PRIVATE INTERNATIONAL LENDING CHANNELS

The area of the international financial system which is the most important in terms of the magnitude of the flows of funds involved, and where constructive changes also have been taking place, is that of international lending through private channels. The international activities of banks especially have grown extremely rapidly over the last two decades or so and this has contributed a great deal to the ability of countries to deal with the large balance of payments disequilibria generated during this period.

International payments imbalances imply return flows of funds from surplus to deficit areas. But such flows do not occur automatically nor do they generally take place on a bilateral basis; in practice the bulk of the funds generated by balance of payments surpluses have in recent years tended initially to be placed with banking institutions in the major financial centres. These banks on-lend them world-wide in response to normal market criteria. The business of intermediating such surplus funds has contributed to the very rapid expansion of the international deposit and lending activity of banks, a major part of which is done through what are generally referred to as Euro-currency markets. From 1974 to 1979, net international lending to final users increased by close to 25 per cent a year and a further significant volume of funds was raised by borrowers through international

bond issues in which international banking institutions also played an important role.

The intermediating role of international banks has on the whole been very useful and indeed necessary in the context of the international balance of payments adjustment process. Very large amounts of funds, which neither international institutions such as the IMF nor national monetary authorities are geared to handle, have been recycled quickly and efficiently. Yet, for reasons on which I will later elaborate and which you as professional bankers will readily grasp, I think it is true to say that the nature of the role banks will play in this area constitutes one of the major challenges that the international financial system will have to face in the 1980s.

THE MAGNITUDE OF THE CURRENT PROBLEM OF PAYMENTS IMBALANCES

Before focussing on the current problems on the international monetary scene, it is perhaps useful to look back briefly and try and see how we have reached the position we are in today.

The oil price shock in 1973-74, coming as it did at a time when unduly expansionary fiscal policies and accommodating monetary policy had contributed to a synchronized boom in the industrial countries and to sharply rising prices for a broad range of basic commodities, undoubtedly added to inflationary problems and reinforced the ensuing

recession. However, although inflationary pressures eased with the slowing of growth, rates of inflation generally remained high and, as countries moved to reflate, price performance tended to deteriorate again. This meant that despite the much higher nominal price for oil which prevailed during the 1974-78 period the real price of oil tended to remain unchanged or even decline. As a result, the incentives for long-term changes in the pattern of energy consumption by oil importers were weakened and the terms of trade again moved against the oil exporting countries. At the same time, the absorptive capacity of these countries proved to be much greater than had been anticipated and as a group they experienced a rapid decline in their current account surplus. The mechanisms for recycling funds also turned out to be surprisingly flexible and responsive. Thus, the world economy was able to ride through these years with less difficulty than had at first been anticipated, although there was, of course, a large transfer of real resources to oil producing countries. However, many countries did not adequately tackle the fundamental problems of inflation and of reducing their dependence on imported oil. Although events in Iran were also a contributing factor, this general world environment had much to do with setting the stage for the second oil price shock.

One of the more worrying aspects of the current situation is that, this time, the problem of world payments imbalances does not appear likely to disappear rapidly. Oil exporting countries are likely to

resist any erosion in the real price of oil. Moreover, the rate at which the imbalance between oil exporting and oil importing countries will be narrowed depends in no small degree on the success attained by the oil consuming countries in slowing down their demand for oil and in developing alternative energy sources. Even so, although demand by oil producers for imported goods and services will undoubtedly continue to be strong, increased absorption is unlikely to result in a rapid reduction of oil generated surpluses, especially given the concerns of some of these countries about the potentially disruptive impact of overly rapid growth on their economic and social fabric.

According to estimates by the IMF staff, prepared before this summer's further rise in oil prices, the current account surplus of oil exporting countries is expected to increase from about U.S. $5 billion in 1978 to around U.S. $115 billion this year and to remain very large in 1981. The main counterpart to this is a swing in the combined current account position of industrial countries from a surplus of U.S. $13 1/2 billion to a deficit of around U.S. $75 billion this year, with some reduction expected next year, while the deficit of non-oil developing countries may rise from just over U.S. $35 billion in 1978 to nearly U.S. $70 billion this year and increase further in 1981.

The prospective current account deficits of major industrial countries are likely to be financed quite readily. However, the pattern of

current account balances can alter rapidly as the very marked changes during the past two years in the position of the United States in one direction and of Germany and Japan in the other have shown. Uncertainties generated by such large swings can become a source of considerable instability in exchange markets. This, together with the tendency for exchange rates to react very sharply at times to shorter term developments, underlines the continuing need for co-operation among central banks of the major countries on exchange market intervention policy.

This year the financing problems of some of the non-oil developing countries have been eased by their ability to draw on fairly comfortable cushions of official reserves and on a large volume of undisbursed bank credit despite substantial disbursement of previously negotiated credit lines in the second half of last year. However, many of these countries have large external debts and rising debt service ratios and the combination of higher prices for oil and other imported goods and of slower growth in their main export markets could well result in a serious deterioration in the position of a growing number of them in 1981. Nor is the outlook in the years immediately beyond 1981 very promising.

Not only are the financing requirements of non-oil developing countries likely to increase sharply over the next few years but the proportion they are likely to be able to finance through private channels may well be significantly smaller. The large remaining gap will have to be closed either

by a remarkable increase in lending by official institutions such as the IMF and the World Bank or through other measures, possibly including drastic adjustments in their imports from other countries. Mounting payments arrears are also a possibility.

THE ROLE OF INTERNATIONAL BANKS

Clearly commercial banks will continue to play a major role in the financing of payments deficits, and appropriately so. However, the increased involvement of banks in international lending, the strong competition between them and the prevalence of a borrower's market through much of the period since 1974 has given rise to certain concerns. It can be argued that countries that have been able to borrow fairly readily on capital markets have been tempted to postpone making necessary adjustments, whether on their own or in conjunction with IMF assistance. Their situations may deteriorate to the point where harsher policies will eventually have to be adopted. I recognize that commercial banks, particularly when they are operating with ample liquidity and in a highly competitive market, may not be in a strong position to insist on the sort of conditions to their lending that would encourage borrowing countries to undertake early measures of adjustment. Banks must, however, be fully conscious of the risks involved.

As bankers you will be well aware that the risks in international lending are not the same as those in domestic lending.

Banks have, no doubt, gained valuable experience over the past few years in developing criteria for assessing sovereign risks as well as other risks in international lending. The fact that much of the lending is done under arrangements whereby the interest rate is adjusted at periodic intervals to short-term deposit rates reduces the interest rate risk associated with maturity transformation. At the same time, this feature increases the uncertainty of debt service costs for the borrowers and, in circumstances of rising interest rates, can lead to a rapid escalation of these costs. Banks have, for good reasons, become more concerned about such matters as the external debt situation of borrowers, the degree of concentration in country exposure, the compression of risk differentiation in spreads and the adequacy of their capital; indeed it has been said that under present conditions the equity base of the international banks is the keystone of the international financial system. Recent events have also reinforced concern over potential political problems. A more cautious attitude on the part of banks has been evident in some tightening this year in their lending conditions.

Banks can generally be expected to diversify their assets abroad much as they would their domestic portfolios and they should not be unduly influenced by market share considerations or by pressure from borrowers. So far the record of losses on international lending has been favourable but the risk of future debtor problems has almost certainly been heightened by recent developments and banks could be faced at least with

increased rescheduling. It is clear that the prospects for repayment are better in the case of countries that adopt appropriate and timely adjustment measures either on their own or in conjunction with a Fund program. I welcome the ongoing reappraisal by banks of their lending policies in the light of such changing circumstances.

Given the importance of the role of banks in recycling, the magnitude of the international capital flows and their significance for both the world economy and the economies of individual countries, developments in this area are, of course, of considerable interest to the monetary and regulatory authorities. They wish to be assured that appropriate procedures are in place for monitoring and reviewing exposure and concentration of risk and for improving the flow of information to banks through the collection of more comprehensive data. Work has been underway for some years, mainly under the auspices of the Bank for International Settlements, to enhance the quality and dissemination of information on international bank lending and indebtedness. Earlier this year, the central bank Governors of the G-10 countries and Switzerland agreed to improve the methods of assessment of country risk exposure and that each would move toward the reporting by their banks of balance sheet information on an internationally consolidated basis. I am happy to say that this is already the case with reports submitted by the Canadian banks.

While I fully agree with the need for regulatory authorities to ensure that sound prudential standards are maintained, I do not share the view expressed in some quarters that, somehow or other, the rapid growth of international lending of itself leads to an uncontrolled and inflationary growth of the world money supply. By and large the amount of liquid assets, including Euro-deposits, that businesses and individuals are willing to hold at any point in time will depend on the level of their income and wealth and on the level of interest rates on competing assets. As Euro-market rates are closely linked by arbitrage to domestic interest rates on assets denominated in the same currency, the implication is that if the growth of the Euro-market has, in fact, contributed to world inflation, this can only be because domestic interest rates in at least some of the major countries have been too low for considerable periods. Moreover, the Euro-currency market provides very clear benefits. For open economies to function efficiently, substantial elasticity in some area of capital flows is required to offset movements in other parts of the balance of payments. If there were not an efficient international market to facilitate these flows, the interest rate or exchange rate movements necessary to achieve short-run equilibrium could be very large indeed. The value of such a market is, of course, even greater at a time when higher oil prices are increasing the need for an even more efficient recycling mechanism.

AN INCREASED ROLE FOR OFFICIAL INTERNATIONAL INSTITUTIONS

The more cautious attitude recently adopted by banks toward their international lending, while not inappropriate on prudential grounds, does suggest that their contribution to the recycling of the new oil-related deficits may be relatively less significant than it was after the 1973-74 shock. On the other hand, official channels can be expected to play a more important role. Agreement was reached recently on an increase in the capital of the World Bank which, when subscribed, will enable the Bank to borrow more on capital markets to fund the growth in its lending. While such operations do not fall into the category of short-term recycling, they can reduce the size of the recycling job that needs to be done. Currently the IMF is well placed so far as the availability of funds is concerned to provide additional financing and the increase in quotas under the Seventh Quota Review, now in the process of being ratified by member countries, will add further to its resources. However, since in current circumstances it may often be necessary to phase adjustments over a longer period and to provide larger amounts in relation to quotas than has been typical in the past, demands on the Fund's resources may well increase substantially. At the latest meeting of the Interim Committee in April this year, it was agreed that the Managing Director be encouraged to "start discussions with potential lenders on the terms and conditions under which the Fund could borrow funds to increase its resources, if and when the need arises".

Like other lenders, the Fund has to be concerned with the ability of borrowing countries to repay. It is aware that some countries have regarded its conditions as being unduly onerous and is endeavouring to encourage countries facing difficulties to adopt corrective measures supported by use of its resources at an earlier stage. This is one of the purposes of the consultation and surveillance process to which I referred earlier. Last year the guidelines on conditionality were reviewed with the intention of ensuring that lending policies are appropriately flexible and reflect an awareness of the particular circumstances of a country. Banks may well find that it is in their own long-run interest to encourage countries in difficulty to turn to the Fund earlier and generally structure their lending policies to support the Fund's role in the adjustment process. This role is crucial because of the Fund's unique ability to exert an influence on the policies of both developed and developing countries. For its part, the Fund recognizes that the commercial banks still have a major role to play in the financing of payments imbalances and hence welcomes the closest co-operation that is consistent with the somewhat different responsibilities of the Fund and of banks.

OFFICIAL INTERNATIONAL RESERVE ASSETS

Another area of concern to the Fund and to others has to do with the implications of a multi-currency reserve system. Although the U.S. dollar remains by far the most important reserve currency,

there has been some move towards portfolio diversification of reserve holdings -- particularly on the part of monetary authorities outside the major industrial countries -- into assets denominated in other currencies such as the Deutschemark, Swiss franc and yen. This has been viewed as having a potentially destabilizing effect on exchange markets.

This was one of the reasons behind the recent proposal for a Currency Substitution Account, whereby participants could deposit some of their U.S. dollar holdings in exchange for SDR-denominated claims on an account managed by the IMF. The objective was to offer official reserve holders an asset subject to less exchange risk than that on any single currency and one on which they would earn a reasonably attractive return. In the event, it has not proved possible to reach agreement on the key arrangements for maintenance of value in the Account. More recently there appears to be a lessening of concern about the development of multi-currency reserves. This is at least partly due to the shift in the balance of payments positions on current account of some of the major countries from surplus to deficit: countries that have deficits to finance tend to be less concerned about capital inflows resulting in investments that are regarded as reserve assets by other countries.

THE POTENTIAL PROBLEM FOR NON-OIL DEVELOPING COUNTRIES

As the time I have devoted to discussing the question indicates, the capacity of private markets and official financial institutions

to recycle funds to credit-worthy borrowers is a matter of immediate and practical interest. But a more pressing problem may well be the inability of many countries to qualify as credit-worthy because of the sheer burden that deficits of the size foreseen over the next few years may well place on an increasing number of non-oil developing countries in relation to their economic prospects. This does not mean that developing countries do not need to tackle problems of domestic inflation and of adjustment to the changed energy situation. In fact, over-reliance on external financing, even if readily available, could lead to delays in making the necessary adjustments and could compound longer term problems.

Uncollectible loans, whether provided by private or official institutions, would not represent an acceptable solution to the problems faced by non-oil developing countries. What some of them mainly need are grants, not loans, but in the present state of the world a substantial increase in aid flows does not, unfortunately, seem likely. If non-oil developing countries are forced to constrain demand severely, there will be an impact on their economies, which for many of the poorer countries could be extremely difficult in social as well as economic terms, and such a development could also constitute a drag on the world economy.

It is essential that this should be recognized and that every effort be made not only to increase unilateral transfers but to avoid putting barriers in the way of non-oil developing countries

increasing their export earnings to pay for imports. A number of developing countries have been remarkably successful in recent years in achieving high rates of growth in part based on the export of manufactured goods. This has added to the problem of adjustment in some of the older industrialized countries and given rise to pressures for increased protection of domestic industries. However, continued strong growth of these developing countries also provides market opportunities, particularly in high technology areas. Protection can only inhibit long-run changes to domestic and international trade patterns that are required to maintain a strong world economy and more efficient and dynamic national economies.

OIL PRICES AND THE CONTROL OF INFLATION

I would like to conclude by returning to what I regard as the important issues facing the industrial countries. A healthy world economy and the smooth functioning of the international payments system will only be achieved if the underlying causes of payments imbalances and inflation are dealt with in the major industrial countries.

Unquestionably, the increased price of oil is contributing to inflation but it is widely agreed -- and this is a more realistic view than had prevailed earlier -- that a higher relative price must in time be accepted. There is considerable scope for more efficient use of

energy, especially by industrial countries, and in this respect there is evidence of a substantial response to higher energy prices, at least over the medium term. At the same time it is important that energy policies should be framed so as to encourage over the medium term the investment required to improve energy efficiency and develop alternative sources, and thereby reduce dependence on imported oil. But it is most important that while accepting necessary changes in the relative price of energy we control carefully the over-all rate of inflation. As was pointed out by the Managing Director of the IMF in a recent speech, "this necessary domestic adjustment in the real prices of petroleum will not be achieved or produce structural changes if higher energy prices are allowed to trigger parallel increases in the general level of prices and in wages. The fight against inflation is thus at the root of an effective energy policy".

On the encouraging side it does appear that we have learned something from recent experience. The experience of the 1970s has brought home to the authorities of many countries the seriousness of the inflationary problem and the need to persevere in policies to combat it. This has been reflected in part in a heightened focus on controlling growth in the money supply and several countries are framing monetary policy around announced targets for growth in monetary aggregates. As a result, the policy reaction to the second oil price shock has differed somewhat from the previous one. In contrast to the mid-1970s, when there was considerable concern about the deflationary impact on demand

and output, the emphasis this time in most major countries continues to be placed on the need to combat inflation as a prerequisite to sustained growth, even at the risk in the near term of a temporary slowing of economic activity. Reflecting this, monetary policy in most industrial countries has generally been firm during the past year and in some countries the stance of fiscal policy has also firmed.

Unfortunately, progress towards the goal of reducing inflation is complicated by the extent to which inflationary expectations have become entrenched. There has been a widespread worsening of inflation throughout the world during the past year and a half, but what is even more discouraging is that an acceleration was evident in the industrial countries in early 1979, before the sharp upward movement of oil prices. In fact, if one looks back over the past twenty-five years, it is clear that the basic trend in the world economy has been towards higher inflation. There can be little doubt that the primary reason for this was the attempt by most countries in the conduct of their policies to achieve and maintain higher levels of output and employment than was consistent with price stability. As a result people have learned to expect inflation and to discount public promises that it will be reduced. It would be a mistake to underestimate the difficulties of turning these expectations around. I am convinced that an absolutely essential element in bringing inflation under control is to keep the rate of monetary expansion within reasonable limits. But I also want to emphasize that

monetary policy is a financial instrument and it operates directly on financial flows in an economy. The way in which real economic variables -- employment, productivity and output -- in the economy respond to changes in financial flows is heavily dependent not only on the state of inflationary expectations but also on other policies and practices throughout the economy. If the goal of reducing inflation is to be achieved efficiently, an appropriate monetary policy must also be accompanied by modifications of various policies and practices -- both in the public and the private sectors -- that contribute to inflation.

So far as the international monetary system is concerned, I doubt that it is now, or ever was for that matter, reasonable to expect any variant of the system to enforce sufficient discipline on countries to ensure that they will always eschew inflationary "solutions" to their economic problems. It is inevitable that national sovereignty will play an important role in this matter. Even under the old gold standard, which had its own difficulties, the discipline it offered could under pressure be escaped by suspending the convertibility of domestic currency into gold or by altering the required ratio of gold reserves to domestic currency. Under the Bretton Woods system of fixed exchange rates it was possible, and indeed if inflationary policies were followed long enough it became absolutely necessary, for a country to devalue its currency. Today we can expect the International Monetary Fund to do

its best to encourage the pursuit of responsible economic policies, but in the end the responsibility must lie, as it really always has, with individual countries. Countries that succeed in avoiding serious inflation may by their example exert a positive influence on others. What we should be able to rely on most of all by now is the accumulated evidence that so far as economic progress is concerned inflationary policies are a dead end.

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INFLATION AND CANADA'S MONETARY POLICY

Notes for a Lecture by G. E. Freeman,
Deputy Governor, Bank of Canada

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Inflation and Canada's Monetary Policy

Never before in our previous history have Canadians experienced such a prolonged period of continuous and increasingly severe inflation as this generation has. Between confederation and the mid-1940's there were certainly episodes of strongly rising prices in Canada, mainly during periods of booming foreign demand for our exports and especially during and after the First World War. But there were also prolonged periods of slower economic growth and gradually declining prices, the most severe of which was the great depression of the 1930's. Thus the level of wholesale prices in Canada at the end of World War II was not very different from what it had been 80 years earlier at the time of confederation. That is why it never would have occurred to my father or to your father, a generation ago, that prices and rates of pay would be much higher when they retired than when they got their first job. It is also why they felt confident that the money they set aside for their retirement savings and life insurance was real money -- not some untrustworthy kind of money whose purchasing power was likely to shrink drastically over time at rates impossible to predict even a few years into the future.

All that has now gone by the board in the space of a single generation. Canadian's have apparently concluded from bitter experience that prices have nowhere to go but up, that as far ahead as one can see tomorrow's inflation is likely to be still more rapid than today's, and that it would be foolish to put much trust in the future value of our money here in Canada. This strongly-held expectation that inflation can only go from bad to worse seems to rest on a

conviction that no democratic government will -- or perhaps even can -- do what is necessary to halt or reverse the process more than very briefly. This expectation has now become firmly embedded both in individual behaviour and in the way institutions function throughout our society.

Of course Canada isn't the only country that has fallen into the grip of chronic, growing inflation. There are a number of countries where the disease has reached a considerably more advanced stage than it yet has in Canada. They are worth visiting for a first-hand look at what a sea of troubles we in Canada could well be heading for. But there are also several countries, like Germany, Japan and Switzerland, that seem to have resisted falling into escalating inflation rather successfully. And it is important to note that their relatively successful efforts in resisting chronic inflation haven't saddled them with a stagnant economy: on the contrary, many of them seem to have achieved a better record of solid economic growth over the years than we have.

Virtually all Canadians who have lived through the last quarter century of growing inflation in this country feel both angry and frustrated. They feel sure that inflation has cheated them very unfairly, but since it's by no means obvious who should be held responsible for this or what can be done about it, they also feel rather helpless. Of course people have a natural tendency to focus only on the ways in which they have been harmed by inflation and to ignore other respects in which they may have benefitted from the process. But there is no real doubt that inflation does indeed distribute windfall gains

and losses throughout the economy in a very arbitrary way, and that the resulting feelings of resentment and sense of injustice are very divisive forces in our society.

I would argue, however, that the harm done by inflation goes well beyond its obvious unfairness. Rising inflation progressively erodes confidence in the future value of our money, and by so doing it progressively undermines the ability of our economic system to function properly. A market economy like ours can only work well, in terms of creating jobs and wealth and enabling us to pay our way in the world, if the value of the nation's money can confidently be expected to remain reasonably stable and predictable over time. As growing inflation makes the future value of our money less and less predictable, it becomes increasingly risky for people to enter into private contracts involving the receipt or payment of fixed sums of money, since there is no redress in any court of law for losses incurred due to inflation.* Rational planning for the future becomes increasingly difficult both for individuals as savers and for businesses investing in capacity expansion. Price increases for particular commodities that consumers and producers would normally take as signals of an impending supply shortfall in relation to the prospective demand become much more difficult to interpret and respond to in circumstances where prices in general are subject to erratic and unpredictable increases. Even rates of interest cease to mean what they normally mean as lenders become increasingly wary of the risk of having their loans repaid in dollars of shrunken purchasing power. To guard against this risk, lenders demand and are able to charge interest rates that incorporate

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*Governments are thus put under steadily growing pressure by groups with political influence to protect their interests through increasing direct government intervention in the market place.

not only a return of the kind traditionally expected for parting with money, but also a substantial premium to compensate them for the impact of expected inflation on the real value of the capital sum repayable at maturity. In short, I believe that inflation must be resisted not just because it is unfair but even more, perhaps, because of the underlying damage it is doing to the healthy functioning of our economy and thus to our longer-term growth and employment prospects.

What has caused countries like Canada to contract the disease of chronic, accelerating inflation since the end of World War II? It might be helpful if I prefaced my answer to this question by explaining the nature of the economic forces that have traditionally worked to keep a lid on the price level in market economies. In an economy operating at normal levels of capacity utilization -- that is, with a normal margin of spare plant capacity and qualified manpower available for employment -- producers who try to set too high a price for their products run the risk of being undercut by their competitors, who can readily expand their production and take over a larger share of the market. Even a producer who is largely protected from competition has to worry about setting his prices so high that his volume of sales and output contracts to the point where his profits decline. Thus in a normally functioning economy which is not suffering from excessive spending pressures there are market forces operating that put an upper limit on the prices it will pay firms to charge their customers. Increased upward pressure on particular parts of the price structure can of course develop at times from a variety of sources. Familiar examples

include major crop failures, OPEC oil embargoes, and outbreaks of inflation abroad or sharp declines in the foreign exchange value of the currency that push up a country's foreign trade prices. For a while this may mean that the whole price level rises faster. Provided, however, that public and private spending in the economy is not allowed to speed up correspondingly, market forces will over time correct this situation by making it increasingly difficult for the prices of other goods and services to continue rising at undiminished rates. Why, then, has persistently worsening inflation become such a problem? What has happened that has tended to weaken or suppress the normal role of market forces in keeping a lid on the price level?

The basic reason for this phenomenon, in my view, lies in the way that fiscal and monetary policies have tended to be conducted in countries like Canada since it became widely known how these policies could be used to help bring a country out of a severe depression such as that of the 1930's. In order to stimulate spending and economic activity in circumstances of this kind, the policy combination recommended by Lord Keynes and his followers envisaged temporary resort to deficit spending by the government together with central bank action to keep interest rates from rising in consequence -- action that would temporarily involve a rapid increase in the quantity of money. This important and useful discovery implied that in extreme circumstances it was quite justifiable for governments to incur large deficits and for central banks to permit more rapid monetary expansion -- provided that these policies were promptly and fully reversed as and when these circumstances changed.

The first and more popular part of this policy prescription has been invoked repeatedly in Canada in recent decades, for a time with remarkable success, as a means of stimulating the pace of economic activity whenever it has shown signs of faltering. The second and less popular part of the prescription has been invoked only fitfully and with great reluctance, so that the necessary shift towards greater moderation in the degree of fiscal and monetary stimulus as renewed expansion turned into impending boom has generally been a case of too little and too late. When undertaken at last, on most occasions the effort to moderate the degree of stimulus to spending has soon been abandoned in the face of slowing growth and rising unemployment -- before it could have much lasting effect in moderating the size of price and cost increases. Thus we have had repeated inflationary over-heating of the economy interspersed with relatively brief and mild recessions, and this has had the effect of greatly reducing the market risks incurred by firms and their employees who push up their prices and wages aggressively.

Because everybody now fears inflation so much and nobody wants to fall behind in the race against it, measures to stimulate spending can no longer be counted upon to do much to raise the level of economic activity before this effect is quickly cancelled out by escalating price and wage increases. By the same token, measures to restrain spending take a long time to moderate established patterns of wage and price behaviour and in the meantime the level of economic activity suffers.

If the worsening trend of inflation is to be halted (let alone reversed), it seems to me absolutely essential that this bias in the way monetary and fiscal policies have been conducted in the past must change -- as I think it has already begun to change in Canada and many other countries. For some time now central banks have been trying to keep the pace of monetary expansion within specified limits and governments have also been trying to limit the growth of their spending and deficits. Everyone connected with these policies is aware of the fact that with expectations of continuing rapid inflation now so firmly entrenched, the process of inflation has acquired too much momentum to be reversed at all quickly without risking major economic disruption. That is why the approach being followed is a gradual and moderate one, the object of which is to be quite a bit more careful and consistent in trying to avoid overstimulating the economy in the years to come than in the past.

In this country the main objective of the Bank of Canada has been to do what it can within the powers given it by Parliament to resist any further worsening of inflation and to help lay the groundwork for an improving cost and price performance over the years ahead. In practical terms this has meant slowing down the excessively rapid growth of money and spending in Canada that enables rapid inflation to continue. To this end the Bank has followed the practice of trying to keep the trend rate of monetary expansion within notional upper and lower limits which have been reduced gradually over time. The Bank is able to operate within this broad framework of longer run monetary growth targets while still retaining considerable latitude in

deciding how to respond in the short run to on-going developments in the foreign exchange market, in money markets and in the economy at large. If developments occur which threaten to worsen Canada's near-term cost and price prospects, the Bank of Canada can take action to restrain the rate of expansion both of the money supply and of total spending in the economy -- though not without putting temporary upward pressure on the level of money market interest rates and quite possibly on the Canadian dollar. Conversely, the Bank can take action that will put temporary downward pressure on money market interest rates in Canada, but only at the cost of loosening its control over monetary growth and the rate of spending in the economy and risking the inflationary consequences of further exchange rate depreciation.

Canadian monetary policy has been conducted within this general framework for about five years. At the outset the target limits for the growth of the money supply, defined for this purpose as currency and demand deposits at chartered banks, were set at 10 to 15 per cent a year. These limits have since been reduced gradually to their current range of 5 to 9 per cent a year. It is obviously disappointing, therefore, that after having fallen for a time well below 8 per cent a year Canada's inflation rate* has since rebounded and now seems likely to be almost as high again in 1980 as it was in the mid-1970's. It would be easy to jump from this to the conclusion that monetary policy in Canada has been misconceived, that it isn't working and won't work as intended, and that inflation in Canada is now essentially out of control. In my view, however, no such conclusions are warranted, and I would like to take a minute or two to explain why I take this view.

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*As measured by the Consumer Price Index.

To begin with, I think it must be admitted that a gradual approach to slowing the rate of monetary expansion leaves little room for inevitable errors in the short-run implementation of the policy, and is unlikely to have as great an impact in moderating inflationary expectations and behaviour as might be desirable.

Even if it were perfectly executed, however, a policy of steady, gradual slowing of the pace of monetary expansion in Canada would be unlikely to result in an equally steady and gradual slowing of the pace of inflation in this country. A much more likely outcome would be a tendency for our inflation rate to follow a short-run path of cyclical upswings and downswings around a longer run trend that was gradually slowing over time. The main reason for this is that the ups and downs of demand, economic activity and inflation that mark the business cycle in the United States are bound to have strong short-run effects on the trend of prices in Canada, and it would be quite unrealistic to expect these effects to be fully ironed out through the influence of Canadian monetary policy. Thus the good progress that Canada seemed to be making against inflation in 1976 and 1977 was partly due to the fact that the United States was in the early stages of recovery from a deep recession, its own rate of inflation was slowing markedly, and this was reflected in waning upward pressure on Canada's price level from increases in our export and import prices. Later on, as this expansion in U.S. economic activity moved towards its cyclical peak and price increases in that country began to accelerate sharply, Canada's inflation rate came under renewed upward pressure from large increases in our foreign trade prices.

The short-run behaviour of the price level in Canada is also bound to be greatly affected at times by major price movements in markets both at home and abroad for particular important commodities, notably foodstuffs, energy and industrial materials. Thus in 1976 and 1977 the slowing trend of food prices was leading the decline in our inflation rate, whereas from 1978 onwards the trend of food prices turned sharply upwards again throughout North America. The steep decline of the Canadian dollar in 1977-78, which was itself the inevitable outcome of past inflationary excesses in this country, also contributed in a major way to the subsequent upturn in Canada's inflation both by raising our import prices directly and by pushing operating rates in many of our export and import-competing industries up against the limits of capacity in 1979.

The fact remains, however, that on the basis of most of the available broad measures of wage and price trends Canada's current rate of inflation is stil significantly lower than it was at the corresponding stage of the previous economic cycle in 1974-75. This is the first time that this has happened in a good many years. In recent months the strong market demand conditions that were pushing many of our industries up against their capacity limits in 1979 and generating large price and wage increases have eased markedly with the onset of the current recession in North America. I am convinced that with a continuing policy of moderation in the rate of monetary expansion our chances are good for achieving a resumption of moderate growth in spending and economic activity in Canada in 1981 and an improving cost and price outlook as we move into 1982.

I would like to conclude with a brief word about the current level of interest rates in Canada. The basic reason why interest rates are so high is because current and anticipated rates of inflation are so high. As I explained earlier in my remarks, the level of interest rates nowadays must be looked at in relation to the inflation rate, which is currently running at over 10 per cent a year. Judged on this basis, the real level of interest rates in Canada today does not seem particularly high by comparison with historical experience. Nor are current interest rate levels in Canada high in relation to comparable rates in the United States: indeed in many cases Canadian rates are now well below U.S. rates, which is quite unusual in terms of their historical relationship.

The argument is often advanced that since interest payments can be an important element in a firm's costs of production, rising interest rates may contribute to rather than work against rising inflation. The weakness in this argument is not that it is wrong so far as it goes but that it is far from the whole story. Suppose that mortgage rates, for example, could be kept at some artificially low level. Would this result in correspondingly low prices for residential properties, or would it not rather lead to a great surge of demand by eager borrowers and a rapid bidding-up of the prices of new and existing dwellings?

The fact is that an attempt by the Bank of Canada to hold down interest rates in the face of widespread expectations of growing inflation would necessarily require faster monetary expansion and risk a serious worsening of inflation.

Indeed, the ability of the Bank of Canada to hold down more than a few particular interest rates for more than a rather brief period in such circumstances would in any event be subject to rather severe practical limits. The extraordinary volatility of interest rates in North America over the past year is primarily a reflection of how sensitive the public has become to the fear of continuing high inflation, and of how sharply views about the inflation outlook have been revised in response to the latest news about short-term economic developments. More often than not the actions taken by the Bank of Canada during this period have served to cushion these rate movements rather than to reinforce them. The only sure and effective way to bring interest rates down substantially in Canada on a lasting basis is to succeed in bringing our inflation rate down substantially on a lasting basis.

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NOT FOR PUBLICATION BEFORE: 1:15 P.M. EASTERN STANDARD TIME
NOVEMBER 13TH, 1980

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE EMPIRE CLUB OF CANADA
TORONTO, ONTARIO
NOVEMBER 13TH, 1980

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to The Empire Club of Canada
Toronto, Ontario
November 13th, 1980

When I appeared before the Standing Committee of the House of Commons on Finance, Trade and Economic Affairs two weeks ago I was impressed by the fact that there are advantages in a forum where the speaker replies to questions because he can then be confident that at least some of his audience are interested in what he has to say. That format helps to deal with the problem of relevance that all speakers face. It avoids the pitfall into which economists have long been accused of falling, namely, answering questions that no one has asked. The risk is, of course, that the speaker may find himself faced with questions that he doesn't quite know how to answer. It has occurred to me that at this luncheon of The Empire Club perhaps I could go some distance towards a Question and Answer format, but with typical central bank caution I myself am going to choose the questions from among those that are frequently asked that I would like to answer today. That seems fair enough to me! So let us proceed.

The first on the list of questions I am asked these days is: Why are interest rates so high? Answer: The basic reason why

interest rates are so high is that current and expected rates of inflation are so high. If you make allowance for the current rate of inflation, interest rates are not in fact unusually high. If you deduct the percentage increase in the Consumer Price Index over the last twelve months, 10.7 per cent, from current interest rates in order to obtain an approximation to "real" interest rates, what you get is 4 to 5 per cent on mortgages, 3 to 3 1/4 per cent on prime commercial bank loans and about zero to one per cent on short-term savings instruments. Interest rates are thus not so high as to provide savers with a large real return before taxes or in many cases with any real return at all after taxes. They are not so high as to discourage borrowers who expect continued high rates of inflation. I am, of course, aware that they are painful to other borrowers who did not expect to have to pay such high rates.

Another question is: Why doesn't Canada have a more independent monetary policy so that interest rates here don't have to move so closely in lock-step with those in the United States? I am inclined to answer that one with another question: Haven't you noticed what has happened this year? Even a cursory comparison of the movements of interest rates in the two countries shows that they have followed quite different paths at times. This year money market interest rates have sometimes been over 4 percentage points higher in Canada than in the United States and at other times over 3 percentage points lower. In recent weeks they have been 1 to 2 percentage points lower. More often than not in the past year the banks' prime lending rate in Canada has been lower than that in the

United States. The Canadian prime rate has ranged from 1 3/4 percentage points higher to 3 percentage points lower than the U.S. rate. At the time these remarks were prepared it was 1 1/2 to 1 3/4 percentage points lower. Spreads between bond yields in the two countries have also varied considerably. Thus Canada is by no means the 13th Federal Reserve District. If further evidence is desired, ask yourself what Federal Reserve District has experienced a decline in the value of its currency relative to other Districts of some 17 per cent in the last four years. I do not mention that particular piece of evidence with any pride, but it is convincing.

The real issue here is not how much interest rate movements in Canada can diverge from those in the United States but how much they should diverge. The exercise of policy independence in this area involves a price. Where on balance does the Canadian interest lie? That is the question. This year the Bank of Canada has felt that the Canadian interest was best served by more moderate swings in interest rates than those that have occurred in the United States; even so, interest rates here have still been quite volatile for much the same reason as in the United States, namely, because the public's views about the inflation outlook have fluctuated so widely in response to the latest news about the economy. The extent to which the Bank of Canada feels that it should moderate these upswings in interest rates is limited by its concern about the inflationary consequences of further significant depreciation of the Canadian dollar and excessive monetary expansion.

What I have said so far will not prevent people from asking the question: Why is the Bank of Canada so concerned about inflation rather than unemployment when the economy is in a period of recession or slow growth? The answer is that the Bank's concern about inflation arises directly out of its concern for unemployment and real incomes. We in the Bank believe that the greatest threat to future economic welfare and employment growth in this country is inflation. We must not jeopardize our longer run chances for growing employment and output by putting aside our concern about inflation in the period immediately ahead. This point was made rather well by the Managing Director of the International Monetary Fund on September 30th when he addressed the annual meeting of that institution. May I quote a couple of excerpts in which he discussed two possible scenarios that the IMF had studied.

> "Assume first that industrial countries persist in their fight against inflation. Given the present very high rates of inflation in quite a few of these countries, this implies that they accept for some time a reduction in the growth of their nominal demand. It may be expected, on this hypothesis, that inflation in the industrial world gradually decreases, that the average rate of growth of real GNP advances from a low level, and that the recycling problem proves manageable. This scenario is certainly not ideal, as it would entail an increase in economic slack. It would, however, restore by the mid-1980s an environment conducive to sustained long-run growth..."
>
> "Our second scenario supposed that demand management policies make an early shift toward expansion. Growth rates might improve markedly for a year or two, but inflation would flare up again and upward pressures on the price of oil

> would intensify. A new shift toward severe restraint of demand would probably then occur, bringing about a fall in rates of economic growth. Those countries with weak external positions would see them deteriorate even further and, toward the middle of the decade, recycling problems would become very serious. Several years would have been lost in the fight against inflation, and inflationary expectations would become even more deeply entrenched..."

The remarks of the Managing Director are related to another question and this time it is one that I want to ask you. Inflation did not used to be a problem in peacetime. What was it that controlled inflation then? Before anyone jumps up to respond to that question I will, as promised, answer it myself. In the past inflation was controlled by the discipline of market forces working in an economic environment where the pressure of demand in markets was only rarely so strong that prices of goods or services could be raised easily and rapidly. What prevented rapid inflation was the fact that any typical business that raised its prices significantly risked the loss of business to its competitors. If they were to survive employers simply had to keep their costs -- including their labour costs -- from rising, and employees could not press too hard for wage increases if they expected their employer to stay in business and their jobs to continue to exist. That is what controlled inflation. That's all there ever was outside of very brief periods of price and wage controls. That's what keeps inflation from getting worse now. This is not to say that no steps could be taken to raise the level of activity at which the Canadian economy can operate without generating higher inflation, and I will

come back to this point. It simply means that inflation will never be controlled as long as the over-all level of spending in the economy is allowed to grow so rapidly that markets can readily absorb large price and cost increases.

The statement that I have just made is really the answer to my next question: Where does monetary policy come into the picture? Monetary policy is mainly a matter of controlling the rate of monetary expansion and thereby affecting the over-all level of spending on goods and services in the economy in an impersonal way. The link between the rate of monetary expansion and the over-all level of spending is interest rates. Interest rates are determined by the interplay of many economic forces including the rate at which the Bank of Canada permits monetary expansion to proceed. Higher interest rates tend to discourage spending; lower interest rates tend to encourage it. Changes in the over-all level of spending in turn give rise to some combination of change in real output and change in the price level.

The extent to which a change in the level of spending is reflected in a change in the price level depends heavily on the level of activity in the economy relative to its effective productive capacity. What level of activity and employment in the economy is compatible with a declining trend rate of inflation? The answer depends fundamentally upon the responsiveness of prices and costs to changes in the over-all level of spending,and that responsiveness depends in turn upon the flexibility of the existing arrangements and practices for setting prices and costs. The more unresponsive price and cost increases are to a moderation of spending pressures in the

economy, the lower the level of activity must be for inflation to subside. Thus anything that can be done to make prices and costs more sensitive to a moderation of spending pressures is very desirable because it will reduce the adverse short-run impact of anti-inflation policy on real output and employment. Indeed a country that depends heavily on market-oriented policies such as monetary and fiscal policies has an obligation to concern itself with how well its markets work.

What are the factors that tend to make cost and price increases unresponsive to a slower growth rate of total spending? There are many such factors. The one that I would put at the top of the list is expectations of future inflation. Strong inflationary expectations reduce the responsiveness of price and cost increases to slowing growth of the over-all level of spending and thereby reduce the level of output and employment unnecessarily during the transition to lower inflation. That's why the need to grapple with inflationary expectations is such an important aspect of anti-inflation policy. That is why it is so important that public policy, including monetary policy, be firmly committed, and be seen to be firmly committed, to reducing the rate of inflation.

There are other factors that also reduce the sensitivity of prices and costs to a moderating trend of total spending. There are sectors of the economy that public policies have largely insulated from market discipline and other sectors where in practice free and keen competition does not prevail. There is also the matter of general attitudes. There is the danger that we come to believe not only that everyone ought to be compensated for increases in

consumer prices, but also that we are all entitled to a better standard of living whether or not it is earned. The fact is that this year the Canadian economy is not producing enough to maintain average real incomes per capita, let alone provide for an increase.

Because in practice the use of monetary policy to moderate excessive spending pressure in the economy involves a temporary slowing of the growth of output and employment, some observers feel that the cost is simply too high to accept and they therefore ask the question: Why does the Bank of Canada persist in its present policy? Sometimes the question is put another way: Why doesn't the Bank bring down interest rates? In either form, what the question must mean is, why doesn't the Bank of Canada permit more rapid monetary expansion and thus more rapid inflation? I believe that many who ask this question do sincerely wish to see inflation controlled, so that in asking it they give evidence of a certain amount of confusion about what is involved.

I say confusion because the fact is that no strategy for dealing with inflation will succeed unless it is well supported by firm and continuing control of the rate of monetary expansion. That proposition is as well established as any general proposition in the whole field of economics, and its acceptance is a basic requirement for any useful debate on how to control inflation. It should not be stretched, however, to include the idea that controlling monetary expansion can by itself deal with inflation in a way that ensures good all-round economic performance. That is not a claim that the Bank of Canada has ever made. Other policies and arrangements in the

economy are also very important. The essential point here is that no matter what measures are adopted in areas such as fiscal policy, or what have come to be called supply-side policies, or even in the unusual case of price and income controls, a key element that must be included in any combination of measures for achieving good economic performance is the avoidance of excessive monetary expansion.

Although I believe that this view about what a central bank should do to control inflation is unassailable, I readily acknowledge that there is room for differing views about the details of monetary policy within this broad framework. I want to discuss this matter but since this is a Question and Answer format I must first find a question with which to begin. One that will serve the purpose and has in fact been asked is: Are the Bank's policies based on oversimplistic monetarist theories?

There does seem to be an impression around that a few years ago some of us in the Bank of Canada were struck down on the road to inflation by a blinding light -- the word "blinding" is sometimes emphasized -- and experienced a sudden conversion to a new far-out religion called monetarism. I have to confess that I was there at the time and that nothing quite so dramatic happened. It is true that we had not been satisfied with the past operation of monetary policy and that we were looking for ways to improve it. It is also true that we have adopted monetary targets to help us in keeping the trend rate of monetary expansion within prudent limits. Monetary targets were adopted because our research work revealed a reasonably systematic relationship in Canada between the trend of M1, a measure

of the money supply narrowly defined to include currency and demand deposits, and the trend of over-all spending in the economy. The use of monetary targets necessarily involves formulating monetary policy with a view to a medium-term time horizon. Adopting this approach therefore meant acknowledging that the time lags between monetary policy actions and their effects on the economy are too long to make it sensible to respond to every short-term fluctuation in economic activity. This was also an important element of change in our approach to the conduct of policy. But that is about all that was involved in our conversion. I assure you that we do not look at the trend of monetary expansion in isolation and that we continue as before to make use of any available indicator in continuously assessing our policy.

I suppose that our adoption of monetary targets made it inevitable that we would be described as monetarists. I was first called a monetarist after a speech I made in 1975 in which, after noting that it was very much in the public interest that the drift into deepening inflation in Canada be halted and reversed, I went on to say that, "Whatever else may need to be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. Any programme that did not include this policy would be doomed to failure. There is no way of preserving its value if money is created on an excessive scale". That, you will have noted, is very much what I have said again today. I continue to believe it. Does that make one a "monetarist"? If it does, there must be few among us who are not

"monetarists" these days. But at times the "monetarist" label seems to be used to mean something else. Next time you see or hear the word "monetarist" used, ask yourself what the user means. Beware of the use of labels: the world of ideas about economic policy is not as sharply divided between monetarists and Keynesians as you may sometimes be invited to believe.

The Bank of Canada does not follow an entirely rigid money supply policy. Not only is our target band relatively wide but we would in fact be prepared to see the money supply move outside the band for a while if we believed that there were good and sufficient economic reasons for doing so, in which case we would feel obliged to explain the reasons. Moreover, within the broad framework set by our monetary targets we see no reason not to give some weight in the short-run to resisting unwelcome developments in the foreign exchange market and to moderating extreme movements in domestic money market interest rates. Over the longer run movements in the exchange value of the Canadian dollar need to be consistent with the achievement of our monetary targets, but in the short-run we do not feel that we should be precluded from resisting movements that threaten to make the subsequent achievement of those targets more difficult. In certain circumstances, for example, a significant decline in the exchange value of the Canadian dollar brought about by unusual interest rate relationships between Canada and the United States would not only add almost immediately to the upward pressure on prices and spending but would also, before long, threaten to put increased upward pressure as well on negotiated wage settlements and thus on our on-going costs of production. I know that some monetary

theorists are uneasy about remarks like this, believing that the trouble with central banks is that they try to ride three horses at once -- the money supply horse, the exchange rate horse and the interest rate horse. It would be easier to agree with them if the money supply always closely followed a highly predictable course but since in its relationship to total spending it tends to wander a bit at times from one side of the track to the other I don't think it a bad idea at least in the short-run to keep a weather eye on those other horses as well.

The battle against inflation is never easy. It has not been easy over the five years during which we have been pursuing monetary targets, and I confess that I am somewhat disappointed with the results to date. I am quite clear in my own mind, nevertheless, that the results would have been even more disappointing if we had allowed even more monetary expansion to take place than we in fact did. In retrospect, given some of the largely unpredictable economic and financial developments that occurred over that period, it might have been better if the moderation of excessively rapid growth since 1975 had been less gradual so that the moderating effect on inflation would have been greater. The fact is, however, that the rate of monetary expansion is now very much less than it was five years ago and I believe monetary policy will have a stronger impact on the trend of total spending and hence on our inflation rate in the period ahead than in the recent past.

It is my basic conviction that a central bank should achieve and maintain firm control over the rate of monetary expansion and that it should muster the patience and resolution to proceed in

that way for as long as may be necessary. A lot of patience will be required. The world economy is highly inflationary and beset with many problems, including the dangerous situation in the Middle East and the serious problems of payments imbalances among countries resulting from the last oil price shock. There are some inevitable price increases ahead that we must absorb without a further lasting escalation of our over-all inflation rate. These seem likely to include food price increases for the next year or so and energy price increases for years to come. It is clear that the battle against inflation cannot be won quickly and this brings me to my final question: Will the Bank of Canada be able to muster the patience and resolution to stay the course? The answer is that it has no other choice. It is not free to give up the fight because that would violate the mandate given to it in the Bank of Canada Act by Parliament "to regulate credit and currency in the best interests of the economic life of the nation". That is our duty, and that is what we intend to do.

Some Thoughts About Supply Policies

Notes for Remarks by
G.E. Freeman, Deputy Governor, Bank of Canada,
at the Ontario Economic Council's Conference on
"Policies for Stagflation: Focus on Supply"
Toronto, November 25, 1980

The problem I want to talk about today has to do with supply responses in the economy to demand policies aimed at reversing the persistent tendency for Canada's inflation rate to rise to higher and higher levels over time.

Suppose for the sake of argument that the demand policies followed are successful in gradually moderating the trend rate of increase of aggregate money expenditure in Canada. As the growth rate of nominal GNE slows down, so must the growth rate either of the quantity of goods and services produced or of the prices at which they are sold (or some combination of the two). It would be very comforting to governments and central banks if they could count on suppliers of goods and services responding promptly to the slackening growth of demand in their markets by accepting correspondingly smaller price and wage increases in order to avoid cutbacks in production and jobs. That would permit an early slowing of the pace of inflation without large transitional effects in the form of reduced output and employment.

But all sorts of reasons can be (and are) advanced for believing that suppliers of goods and services will in fact tend to respond rather differently -- not forever, but perhaps for an uncomfortably long period of time.

They will, it is said, resist scaling down the size of the price and wage increases to which they have become accustomed much more strongly than they will resist cutbacks in production and employment.

To what extent is this rather bleak view of the supply behaviour to be expected in response to disinflationary demand policies well-founded? And to the extent that it does seem to be soundly based, are there any remedies available which might help us achieve a gradually improving cost and price performance without having to resign ourselves to a prolonged period of sluggish economic growth?

The effective capacity of an economy to produce goods and services at any point in time is of course not unlimited. The basic determinants of capacity include the size of the economy's existing real resources, capital stock and manpower; the efficiency with which existing management and labour skills, technology and institutional practices enable these resources to be used to produce goods and services; and the degree to which the resources available can readily be adapted to produce on a profitable basis the pattern of output currently in demand. Gradual changes in these underlying factors broadly determine and similarly limit the trend rate of increase of an economy's effective productive capacity over a period of years.

Economists are also familiar with the notion that as the over-all operating rate of an economy rises closer and closer to the limits of its existing productive capacity in response to a rapid expansion of demand,

supply bottlenecks of various kinds will begin to loom on the horizon in more and more areas of the market. This will enable suppliers of goods and labour services to obtain larger price and wage increases than they could otherwise obtain, given the much reduced risk of being undercut by competing suppliers and losing sales volume. Conversely, as demand expansion slows down and the over-all operating rate of the economy declines, excess capacity and an over-supply of labour will begin to emerge in more and more areas of the market. This will make it increasingly difficult for suppliers of goods and labour services to obtain such large price and wage increases without incurring the risk of losing sales and jobs.

Is it reasonable to expect there to be some aggregate level or range of operating rates in relation to productive capacity between these two extremes which, if maintained more or less consistently in an economy not subject to major supply shocks, would be unlikely to put strong upward or downward pressure on the over-all trend of prices and costs? Many economists think so, although they haven't yet come up with a more satisfactory label for what they mean than terms such as "the natural rate of unemployment" or "the level of capacity utilization consistent with non-accelerating inflation".

If there is indeed some rough upper limit of this kind to the levels of capacity utilization at which our economy can currently be expected to operate without generating faster inflation, it would seem to be important to establish as objectively as we can where it might lie, and to give the existence of this limit considerable weight in the formulation of current economic policy.

There has been a lot of wishful thinking on this matter in the past, and in many quarters there still is. Thus estimates are frequently made of how much output the economy would be capable of producing if it were to operate at the limits of its physical capacity, without regard to the degree of accelerating inflation this could be expected to generate. Such estimates are obviously suspect if you believe, as I do, that growing, chronic inflation is bound to do increasingly serious cumulative damage to the effective functioning of the economy. These highly suspect estimates are then compared with the actual output of the economy in order to arrive at some figure purporting to measure how much potential output is being lost as a result of a failure on the part of the authorities to stimulate demand sufficiently. The figures produced in this manner are often, quite predictably, enormous. I would suggest that at the very least output gaps of this kind should be arrived at by comparing actual output with the quantity of output realistically achievable without generating further acceleration of the rate of inflation.

It would also seem important to recognize some of the other implications of an upper limit to capacity utilization in the economy beyond which we shouldn't be surprised to see our trend rate of inflation accelerate. An economy in which the level of activity had reached this critical range of capacity utilization wouldn't have to come to a full stop in order to avoid the risk of accelerating inflation. Its output could continue to grow in line with the growth in its productive capacity without raising its rate of capacity utilization into the danger area. Whether this would mean a high rate of growth or a low one

would depend on how rapidly productive capacity was in fact expanding. If it were at a low rate, faster demand expansion by itself could raise output growth only by risking faster inflation. But there might well be other areas of policy in which effective action could be taken to permit faster growth without inviting faster inflation -- a question to which I intend to return later.

It also follows that the maintained level of capacity utilization in the economy which would be consistent with a declining trend rate of inflation would have to be lower than that required merely to keep inflation from accelerating. How much lower would depend partly on how rapid a decline in the inflation rate was the objective of policy and partly on how strongly suppliers of goods and services tried to resist adapting their price and wage behaviour to market realities. Here again the question arises whether there might not be significant scope in practice for effective policy action to hasten the desired change in price and wage setting behaviour.

There is one additional observation I would like to make about the relationship between the degree of pressure on capacity that is allowed to emerge in an economy and the associated trend of its inflation rate. Not only is the growth rate of capacity itself (for a variety of reasons) subject to change over time, but the same is true of the price and cost behaviour likely to be associated with a given degree of pressure on this productive capacity. I think there is convincing evidence that over recent years both have changed in ways that unfortunately have greatly increased the difficulty

of improving our cost and price performance. The trend rate of increase of the productive capacity of our economy has undoubtedly slowed down, while at the same time the inflationary character of the price and wage responses evoked by a given degree of pressure on capacity has strengthened markedly. In part the reasons for this have to do with underlying factors such as demographic trends, the impact of much higher cost energy on the profitable employment of existing energy-inefficient capital, and so on. But there have also been deep-seated changes in expectations and behaviour stemming from what people have learned from recent experience of growing inflation. In addition, the rapidly expanding role of government has favoured a correspondingly rapid development of institutional arrangements that provide a growing number of influential groups in the economy with varying degrees of insulation from the need to adapt to market forces -- arrangements that help to prop up costs and prices, or even to keep pushing them up, in the face of slackening market demand. We probably can't do much about some of these things, but perhaps something useful could be done about others. That's what I would like to turn to now.

From what I have said so far, it should be apparent that I too, as a central banker, share the concern felt by many other economists that an improving cost and price performance in Canada is unlikely to be achieved very quickly by demand policies alone even with the economy operating at relatively conservative levels of capacity utilization and growing more slowly than we have been accustomed to in the past. What I don't believe is that we

have the option of using demand policies to generate a much higher rate of growth and level of capacity utilization than those in prospect. Such effects wouldn't last long; the main lasting effect would simply be a further escalation of our underlying inflation rate. The question is, do we have the option of taking other policy initiatives in addition to demand policies that could realistically be expected to improve Canada's growth prospects during the transition to lower inflation?

Some economists who share my view of how important it is to break the grip of chronic, growing inflation on the Canadian economy argue that the demand policies required to bring this about would be more acceptable to the public if they could be supplemented by effective policies on the supply side to raise productivity and growth and perhaps to combat more directly the apparent downward rigidity of cost and prices. They are also concerned about how demand policies should be conducted in the face of a major supply shock such as the series of large increases in energy prices that seem to be in store for us here in Canada over the next few years. They don't want us to accommodate any more inflation than can be helped, but at the same time they don't want to see economic activity depressed any more than can be helped.

I can assure you that these same concerns are very much in our minds at the Bank of Canada. If there is a realistic hope of achieving a more satisfactory outcome by enlisting the help of other policy initiatives in addition to demand policies, we would be the last to reject such help as we could get. But if such help is not really possible or is not forthcoming, we will nevertheless have to press on in our own area of responsibility doing the best we can.

I might as well admit at the outset that I am not terribly optimistic about the chances of getting major help from supply policies very quickly in improving the growth performance of the economy as the attempt is made to bring inflation under better control. There doesn't yet seem to be more than partial knowledge of the various factors which have caused the trend rate of productivity improvement in countries like Canada to decline to the extent that it has over recent years. This makes it correspondingly difficult to know where to turn to find effective ways of raising the growth of productivity. It is often suggested that one of the more promising areas for constructive action in this regard lies in the micro-policies of the various levels of government. Much could be done, it is said, by reducing the disincentive effects of existing systems of taxation, by weeding out unnecessary regulatory measures that hobble enterprise, by putting greater emphasis in industrial development policies on identifying and backing potential winners than on propping up obvious losers, by adopting a more selective and cost-conscious approach to environmental and similar affirmative action measures, by rationalizing manpower policies and labour codes, by supporting research more handsomely, and so on. No doubt many of the measures adopted by governments as a means of promoting worthy causes do indeed have unintended adverse side-effects on the economy's productivity performance, and could stand design improvements or in some cases deserve to be scrapped in the interests of achieving a more efficient and dynamic economy. I am all in favour of such efforts. But realism suggests that policy improvements of this kind are difficult to come

by for all sorts of practical and political reasons, and that such progress as we can realistically expect is unlikely to be rapid enough to improve our near-term growth prospects in any major way.

What about policies designed to help bring about a more prompt scaling down of the size of price and wage increases as the growth of nominal demand moderates? Incomes policies of various kinds -- both voluntary and involuntary -- have been tried at times in Canada, the most recent being the mandatory system of wage and price controls introduced in 1975. Temporary schemes of this kind hold out the hope that any unavoidable damage they might do to the efficient functioning of the economy is unlikely to be lasting, but by the same token such improvement in the process of wage and price determination as they achieve is difficult to maintain once the program has ended. That is perhaps one of the reasons why alternative approaches, such as tax-based incomes policies, seem to be taken more seriously nowadays than the idea of making direct wage and price controls a permanent feature of our society. I remain to be convined that any form of tax-based incomes policy has yet been devised which would meet even minimum standards of workability, equity, or reliability in achieving the results desired from it. Some economists believe that the downward rigidity of established patterns of wage increase is largely attributable to emulative trade union behaviour under a fragmented, staggered-date system of collective bargaining. They too, however, hold out little hope of any early movement in North America towards a more centralized German or Japanese-type bargaining system.

In addition to institutional rigidities of various kinds, an important reason why price and wage behaviour tends to be highly unresponsive -- at least in the short run -- to a moderation of demand growth would seem to lie in the area of expectations. The public has heard repeatedly from governments and central banks that they are determined to hang tough against inflation, whatever difficulties this may create in the short run. But in practice the degree of resolution shown has rarely matched the intent, and the public has repeatedly seen the inflation rate dip for perhaps a year or two and then rise again to a higher level than ever. It should not be surprising that the public has learned from this experience not to put too much trust in official declarations promising firm action against inflation. How would an employer feel who had believed what he had been told, taken a costly strike in order to get a wage settlement that would seem reasonable in a less inflationary environment, and then found that the rug had been pulled out from under him because the authorities hadn't really meant what they said? I don't see any cure for this other than for policymakers to be very careful to promise the public no more than they feel sure they can perform, and then to show by their subsequent performance that they mean what they say. I think that this might well eventally ease some of the difficulties presently encountered in trying to moderate inflation through demand policies.

A Statement by
Gerald K. Bouey
Governor of the Bank of Canada
At a Meeting of the
Federal and Provincial Ministers of Finance
Ottawa, Ontario
December 17th, 1980

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I welcome the opportunity to be present at this Federal-Provincial meeting of Ministers of Finance and to respond to any questions you would like to raise about the monetary policy that is being followed in Canada. Before doing so I thought a brief introductory statement might be helpful.

My statement falls into two parts. The first part addresses the immediate problems posed for Canadian monetary policy over recent weeks, as a result of the very steep run-up of short-term interest rates in the United States and the associated downward pressure on the Canadian dollar. The second part deals more broadly and in longer term perspective with the basic policy being pursued by the Bank of Canada.

Over the past two months short-term interest rates in the United States have shot up. The prime lending rate of U.S. banks, which was 13 1/2 per cent on October 16, rose in rapid steps to 17 per cent on November 21 and to 21 per cent yesterday. Money market rates in that country are approximately double the level of last July.

The recent upsurge of short-term interest rates in the United States to extremely high levels is part of a pattern of extraordinary interest rate volatility in that country during 1980. No doubt you will recall that U.S. rates shot up to much the same extremely high levels last spring, and then plunged with equal rapidity to extremely low levels early in the summer. I welcome the determination of the U.S. authorities to fight inflation but such wide interest rate gyrations in the United States, whether to extremely high or to extremely low levels, pose very difficult choices for monetary policy in Canada.

In the present case, the rapid run-up of U.S. short-term rates to such high levels is bound to have a major impact on Canada through increases in interest rates here or through a fall in the foreign exchange value of the Canadian dollar, or some combination of the two. The problem does not originate in Canada and the Bank has no way of dealing with it that will not affect either the level of interest rates or the exchange rate or both. The Bank of Canada could, if it chose, try to resist firmly the upward pressure on Canadian short-term interest rates exerted by steeply rising interest rates abroad and accept the inflationary repercussions on our own economy of a sharp decrease in the foreign exchange value of the Canadian dollar as investors responded to the widening gap between interest rates in this country and the rates obtainable south of the border. On the other hand the Bank of Canada could, if it chose, firmly resist any downward

pressure on the Canadian dollar by ensuring that short-term interest rates in this country rose as fast and as far in relation to rates abroad as might prove necessary for the purpose. In fact the Bank of Canada has chosen a course of policy which lies between these two extremes. Canadian short-term interest rates have risen considerably, though not nearly as fast or as far as comparable rates in the United States. Back in July short-term rates were roughly 2 per cent <u>higher</u> in Canada than in the United States; currently they are 3 to 4 per cent <u>lower</u> in Canada than across the border. So much for the allegation that it is Bank of Canada policy to force Canadian interest rates to move in lock-step with U.S. interest rates. Over the same period the foreign exchange value of the Canadian dollar has declined from around 87 1/2 cents U.S. to as low as 82 1/2 cents yesterday morning. So much for the allegation that Bank of Canada policy is to keep the Canadian dollar at some predetermined level.

The reason why there is a very real limit to how far the Bank of Canada can prudently go in present circumstances in insulating the Canadian interest rate structure from steeply rising interest rates abroad and accepting the exchange rate consequences of such a policy is the danger of making our already severe inflation problem considerably worse. It would not be safe to assume that the consequent decline in our dollar, or the high U.S. interest rates that precipitated it, would be quickly reversed. We could expect the domestic prices we have to pay for our

imports and for the export-related commodities we consume here in Canada to rise before long by a substantial proportion of the percentage decline in the foreign exchange value of the Canadian dollar. In Canada's current environment of highly-charged fears and expectations of worsening inflation, a substantial jump in prices that raised our present double-digit inflation rate even higher would be likely to trigger off a further escalation of wage increases. Thus whatever competitive advantage our export and import-competing industries might gain from further depreciation of the Canadian dollar could quickly be eroded by a further escalation of their on-going labour costs. The risk of such an outcome may be somewhat lower now than it was a year ago when most of these industries were pressing against the limits of their productive capacity, but it is still very real. The end result, in all probability, would be to compound our inflation problem with little or no lasting benefit to our near-term growth prospects.

I believe that the course of action followed by the Bank of Canada in response to the recent upsurge of U.S. interest rates has been both moderate and responsible in all the circumstances. The day is long past for running serious inflationary risks in our economic policies here in Canada. If the only responsible options left to us are ones that are both unpleasant and unpopular, we had better face up to that fact.

This brings me to the second part of my introductory comments. For several years now the basic objective of Canadian monetary policy has

been to moderate gradually over time the pace of monetary expansion. This policy approach is based on a conviction that whatever else needs to be done to reverse the drift into ever-deepening inflation, no strategy for doing so will succeed unless it is supported on a continuing basis by firm control over the process of monetary expansion.

How has this policy approach worked out in practice? The trend rate of increase of the money supply and of total spending has indeed been moderating, although at times the pace of progress in this direction has been less steady and more gradual than intended. Over the past one and a half years money supply growth has been in a range of 5 to 9 per cent (annual rates), well below the rates of increase seen earlier in the 1970s which at times reached 15 per cent a year. Total spending in the economy (that is, the dollar value of gross national expenditure) has risen by about 9 per cent over the past four quarters, a rate of growth well below that of the previous four quarters and much below the rates of up to 20 per cent a year seen earlier in the decade. To date our inflation rate, however, has not moderated correspondingly. After falling back for a time a bit below the double-digit rates reached a few years ago, as measured by the Consumer Price Index, it has since turned upwards again and over the past twelve months has been in excess of 10 per cent.

The fact that our inflation rate is still as high as it is in spite of the moderating trend of money supply growth and total spending

in the Canadian economy is interpreted in some quarters as evidence that the monetary policy approach we have been following is not working. I believe this view to be mistaken. It seems to me that what has happened is that the mild and gradual downward pressure on prices stemming from our efforts to moderate monetary growth and spending has been exceeded for the time being by the strength of upward pressures on costs and prices from a number of other sources. Although a temporary reverse of this kind can happen, and seems to have happened, I am confident that firm persistence with the monetary policy we are pursuing will help to offset the impact of these particular pressures on the over-all price level, and will lead in time to a renewed decline in our over-all inflation rate.

Some of the sources of recent strong upward pressure on the price level that I have referred to are not difficult to identify. Over the past year or two much higher rates of price inflation in the United States and abroad, taken in conjunction with the recurrent weakness of the Canadian dollar, have resulted in rates of increase in the prices we pay for a wide range of export-related commodities and imports (other than subsidized oil imports) well in excess of those for most other goods and services. The special problems of world energy and food supply and prices in relation to the trend of prices in Canada are well known; they have also worsened considerably over the past year with no early relief in sight. The fact that the output capacity of the Canadian economy, like that of most other industrial countries, has not been growing nearly as fast

as it used to because of the slowdown in productivity helps to explain why many of our industries began to press against the limits of their productive capacity in 1979 and to generate larger and persisting price and wage increases. These particular sources of upward pressure on the price level have been reinforced by fears and expectations that inflation is out of control and bound to get worse -- fears and expectations that feed directly into wage and price-setting behaviour and that in the short-run tend to become self-fulfilling. These are some of the powerful forces working against the anti-inflationary influence of gradual monetary restraint.

What moral should be drawn from the experience we have had with monetary policy over recent years? First, I believe that we could have made more progress against inflation, in spite of these upward pressures on the price level, if the monetary policy followed had been less gradual -- if the pace of monetary expansion had been brought down more promptly and steadily and if, to this end, interest rates had been allowed to rise faster and further at an earlier stage. An important corollary to this conclusion is that an easier monetary policy than the one actually followed would have resulted in a still higher rate of inflation than we are now experiencing. Another conclusion that might be drawn with the benefit of hindsight is that it would have been useful to reinforce the monetary policy that was actually in place with stronger anti-inflationary action in other areas of public policy to the extent that this was feasible. We must recognize that if inflation is to be brought under control demand management policies,

including monetary policy, must be pressed to the point where markets for goods and services are not buoyant enough to allow prices to be raised rapidly even though this may mean, at least for a time, more slack in the economy than we would like to see.

The problem of reducing the rate of inflation in Canada has turned out to be more difficult than I had hoped five years ago that it would be, and in that sense I am disappointed. But insofar as monetary policy is concerned, Canadian experience underlines the necessity of continuing firm restraint, and that is the policy that the Bank of Canada intends to follow. We welcome all the help that we can get in the struggle against inflation. The most effective form of help is for all other groups in the community, including governments, to conduct their own affairs in ways that help to reduce cost and price inflation.

TRANSCRIPT OF REMARKS TO THE PRESS FOLLOWING
THE STATEMENT BY BANK OF CANADA GOVERNOR GERALD BOUEY
TO FEDERAL AND PROVINCIAL FINANCE MINISTERS
IN OTTAWA, DECEMBER 17, 1980.

QUESTION

According to your statement that there are, roughly speaking, two extreme courses that Canada could follow in the present situation, you have decided to steer down the middle. Is there not a risk in that though, that you get the worst of both possible extremes as we seem to be having now?

MR. BOUEY

No, I don't think so. I think that somewhere in the middle is better than either end.

QUESTION

To be quite blunt about it, there is probably a perception in the country now, given the fact that we went through this last spring, that there is very little that Canadian economic planners can do about this and that, in fact, you gentlemen really don't know what you are doing either, which is not meant pugnaciously on my part. It is simply that you are working in a whole new ball game, if you like.

MR. BOUEY

Well, we do know what we are doing, to coin a phrase. We do know that we don't want interest rates as high as those in the United States and we have so far succeeded in keeping ours from being as high. We also know we don't want too weak a Canadian dollar and we regret the weakness that has occurred. But we think we kept it within reasonable bounds. So I think this result is the best we can manage at the present time and it does represent, I think, a far better outcome than either extremes.

QUESTION

Mr. Bouey, do you believe that prime interest rates of 21 per cent are the right policy for this time? Do you believe that they will make a significant impact upon inflation and inflation expectations?

MR. BOUEY

I think that interest rates that high would have an impact on inflation and inflation expectations if they are kept there for a while. I don't think Canada needs to have them that high in order to have enough impact on inflation and inflationary expectations.

QUESTION

But my question, which I didn't phrase perhaps as well as I might have, was do you think it is the right policy for the United States? In other words, would you be doing what you were doing except that the United States is doing what it is doing and you wish that the United States were not doing what it's doing?

MR. BOUEY

Well, I don't think that I want to tell the Americans how to run their affairs. I can say that it would be much easier for us if they had somewhat lower interest rates.

QUESTION

Governor Bouey, since Mr. MacEachen had said both in and out of the House of Commons that you expressed the same concern you just mentioned at last week's meeting of the central bank governors and since you were there representing, as a public servant, all Canadians, could you please tell us today how you expressed that concern, who you expressed it to and what you told them?

MR. BOUEY

Well, I can tell you how I expressed the concern - exactly the same as the first paragraph on page 2 in the statement. I can read it out to you if you'd like. "The recent upsurge of short-term interest rates in the United States to extremely high levels is part of a pattern of extraordinary interest rate volatility in that country during 1980. No doubt you will recall that U.S. rates shot up to much the same extremely high levels last spring, and then plunged with equal rapidity to extremely low levels early in the summer." Now this is really what I said. "I welcome the determination of the U.S. authorities to fight inflation but such wide interest rate gyrations in the United States, whether to extremely high or to extremely low levels, pose very difficult choices for monetary policy in Canada."

QUESTION

The impression that has been given in the House of Commons and outside the House of Commons is that this concern, the way you have expressed it, almost took the form of a formal protest on behalf of Canada to the United States. Was it simply a discussion around the table, part of a general economic discussion, or was it in effect a formal protest?

MR. BOUEY

I don't go around making formal protests. It is not my job. What I do do is attend meetings of central bank governors. There are regular meetings of that kind and there is a good exchange of views. I express my views. The meeting is somewhat like the one that is going on in the next room. It is a private, confidential meeting and I don't repeat the views expressed by other people at that meeting.

QUESTION

Mr. Bouey, I think the politicians are interested in your views, and certainly the public is, and if we follow the logical extention, if you like, of the existing policy that you are maintaining now, is there, in your view, a cut-off point where the Canadian interest rate simply cannot float "any higher"? How high can we go before the system, as you see it, market forces, react the way that you forsee them?

MR. BOUEY

I am not sure what the last part of your question is. I am not prepared to say that I know of some definite point where interest rates are not going to go higher. I don't know that. I will have to see how the situation develops.

QUESTION

Well, what is your view? Have we gone about as high as we can go now before it would be your recommendation to the government that some form of action must be taken?

MR. BOUEY

Well we already have gone higher than I would like to see. But, in fact, we haven't got any good choices open to us. I am not going to say to the

government you better do something because I don't know of anything more that we can be doing.

QUESTION

First of all, why has there been this volatility of rates? Has it been bad policy making on the part of the Federal Reserve?

MR. BOUEY

Well, I am not going to attempt an assessment of their policy. Their economy itself has been a bit volatile. The inflationary expectations have been a bit volatile and the way they control their money supply has, given all these other things, resulted in this kind of volatility. Whether that is bad policy or not is not a question I am prepared to answer. From their point of view, it may be the best policy they can manage. From our point of view, a policy that involved much less interest rate volatility would, of course, be much preferable.

QUESTION

At the bottom of page 7 and top of page 8 of your statement, reading between the lines and it seems to be very clear between the lines, you seem to be saying that we need a much sharper recession, a much harsher downturn, to overcome inflation and inflationary expectations. Is that a fair interpretation?

MR. BOUEY

I am glad to see that reading between the lines is so clear. Some of my best writing is between the lines. No, I am not saying there should be a sharper downturn here. If, for example, you look at the projections in the last budget, you will see slow growth projected, unemployment rising. It seems to me that we are most likely in for a period of slow growth and quite a lot of slack and I am not suggesting that we should suddenly turn and follow much stronger policies of restraint. That is one reason I don't like to see interest rates as high as they are. But I think we do have to continue a firm policy of monetary restraint and that's what we intend to do.

QUESTION

How long do you see these policies of restraint being needed?

MR. BOUEY

I think we have to operate with our markets in a position where they are not so bouyant that it is as easy as it has been to raise prices. It is rather hard for me to say exactly how much slack we need in the economy to accomplish that. I would hope it would not be too much but it might be a fair amount. Once one does achieve that kind of situation, then it is not necessary to go on producing more and more slack in the economy. At that stage, one, I would hope, could resume a growth path more in accordance with the potential growth of the economy, which unfortunately is rather low these days.

QUESTION

Governor Bouey could you say whether you think that higher prices for domestic oil and the consequent encouragement presumably that would happen for large projects such as tar sands would strengthen the Canadian dollar in itself and give you greater flexibility in setting interest rates so that we wouldn't have to track the Americans as much.

MR. BOUEY

I am not getting into the oil price debate here. Oil and money don't mix in this meeting.

QUESTION

Would you recommend at this time, then, another alternative which has been suggested but which has been seemingly ruled out for the time being anyway, do you think it would be a good time in the forseeable future to move into another program of wage and price controls?

MR. BOUEY

No, I am not suggesting that at this time.

QUESTION

Governor Bouey, you admit that your monetary policies haven't brought down inflation and in fact unemployment is worse than it has been. But you say that the reason is that your policies were not applied early enough or sharply enough. How far down the road do you have to go, how high does inflation get or how high does unemployment get before you start to consider whether monetarism is actually working?

MR. BOUEY

Well, monetarism is your word, not mine. Our policy, I think, is working. It hasn't produced, or it has been perhaps more gradual than would have been wise in all the circumstances. But the reason for that is that the Bank, as I think you would expect, is very anxious to avoid any more disruption in the economy than is absolutely necessary, any more slack than is absolutely necessary, and we encountered quite a number of forces which are mentioned in the paper that were not anticipated. But it is the case now that the rate of monetary expansion is very much less than it was 5 years ago and I think it will, therefore, have a much firmer impact in the future than it did in that period when we were coming down very gradually.

QUESTION

Governor Bouey, one of the major concerns of financial markets these days is that the sharp volatility in the interest rate climate could inadvertently trigger a collapse, or a run on financial institutions. I was wondering how you evaluate that risk? How high do you put it?

MR. BOUEY

I am not greatly concerned about that at the present time. We went through a period very much like this last spring, very much like this indeed, and got through that all right and I think since that time financial institutions have been more careful than before to try to match the term of their assets and the term of their liabilities, so that they are not caught out. There is not much danger of being caught out now as there was before. Of course I am aware that it is still quite difficult for some of them.

QUESTION

Mr. Bouey, I wonder if I could ask you a couple of questions not related. The first one, you were a lot longer in there than we expected, probably longer than you expected, because you called your press conference an hour earlier. Can you give us some idea of why things were tough in there?

MR. BOUEY

I thought we had a pretty good discussion. I thought the finance ministers were pretty interested in monetary policy. They asked a lot of good

questions. I think you should ask them why they wanted to take so much time. It didn't take me so long to read my statement.

QUESTION

As a short follow up, though, did you find that most of them were in agreement with your statement or were they all kind of, without getting into details, were they negative, positive, somewhere in between?

MR. BOUEY

I left to wild applause.

QUESTION

How nice for you. Let me try another tack. A lot of this stuff is fairly difficult for us and perhaps even more difficult for our viewers. But it seems to say that you are going to continue on, that seems to be the bottom line, that you hope that things will turn around, that things are going to get better. I assume that you have analyzed how other industrial countries are attacking similar problems and are there any other solutions that interest you? Are there any other roads, any other avenues that you are watching, any other country's example that you are watching, and are at least interested by?

MR. BOUEY

Well I think I should restrict my comments on that simply to monetary policy. No, I don't find other countries operating very differently. In fact, I would say there is general agreement about how monetary policy should be conducted these days. It doesn't mean that everybody has the same targets. There are some central banks that don't operate with targets. But there is absolutely no question that every central bank in these industrial countries feels the rate of monetary expansion has to be kept under close control if we are going to solve this inflation problem, and I haven't seen any different techniques than we use. Well, the Americans use a somewhat different technique. I think it does produce a little more volatility in rates. I haven't seen anything new in the world recently. I have seen a lot of determination. I think the way the Germans and Japanese have managed their affairs shows a lot of determination. But I think there are a lot of other things involved there besides monetary policy.

QUESTION

Are any of them doing a lot better than us? Any of them following different paths, doing a lot better than us?

MR. BOUEY

Well, some of them didn't allow their inflationary situation to go as far as ours did in the seventies. I think one has to admire a bit the way the Japanese and Germans, who have huge energy bills, have had to accept the world price and nevertheless kept their inflation under pretty good control. I think one has to admire that a bit. They haven't had to have as high interest rates as we have had because their inflation rate has not been as high. So there is a lot of aspects of policy there other than monetary policy.

QUESTION

Governor Bouey, two questions. On page 6 of your statement, you talk about strength of upward pressures on costs and prices from other sources and you call this a temporary reverse. The Finance Department in the October 28 budget and the Economic Council recently suggested that these prices would actually be higher next year. How long is a temporary reverse? Is it a year, a year and a half?

MR. BOUEY

Well it is temporary. That is about as close as I can come to. I hope it is not too long but we do have these pressures.

QUESTION

But you don't have any sort of timing - 6 months or a year - that we are going to watch this trend?

MR. BOUEY

I think it is going to be hard to make quick progress against inflation in the next year or so. I hope we can make some. We do have rising energy prices to contend with and that will go on year after year. We do have food prices that are likely to rise quite a lot in the next year. I don't know that that will go on indefinitely. But that is going to be difficult for us. But I think in time we will succeed in getting the inflation rate down.

QUESTION

The second question has to deal with dollar. Traditionnally you tried to keep it within the 87-83 cent range. We are now well below that. At what point do you become extremely concerned about the level of the dollar? Is it 80 cents?

MR. BOUEY

Well, let me say first of all that we have never had a policy of keeping it in any particular range; 83-87 is your range, not mine. I'm unhappy about the Canadian dollar being as low as it is. But I think we have to accept something like that in order to keep our interest rates from being much higher. I don't like that combination, but as I've said before, I think that is the best we have been able to achieve at this time. I think that's about as far that I can go in answer to that.

QUESTION

Mr. Bouey, I have a second question about the temporary reverse which you refer to the present inflationary pressures, which you say could, provided the right monetary policies are followed, could lead in time to a renewed decline in our over-all rate of inflation. Well, of course, the temporary reverse followed a previous decline which followed in turn a previous reverse. What makes you convinced that inflation is something that can be cured and that it is not the temporary reverse that has become permanent and the renewed declines the exception to the rule?

MR. BOUEY

Well, I have no doubt that inflation can be cured. One can operate policies that are so tough, with markets so weak, that it is impossible for people to raise their prices. Extremely high interest rates, extremely high taxes, there are various ways of doing it. The whole problem is to try to do it without causing too much pain in the system and naturally I think we've all been concerned about that. I think all the mistakes we have made in monetary policy have been in the direction of taking too much of the risk on the side of inflation because like other people we are terribly concerned about things like unemployment. That is why we have followed this up and down path. But I think we do have to be firmer in the future and we intend to be.

QUESTION

As my next question, what do you mean by firmer in the future? There is a suggestion in your statement that you are looking at the money supply now and you have some questions about your own policies in the past there. What can we look forward to?

MR. BOUEY

You can look forward to a rate of increase in the money supply that is not too high.

QUESTION

Is there anything else that you are contemplating to deal with this short-term situation?

MR. BOUEY

Well now you are switching to the short-term situation. I was looking at the money supply. No, there is nothing else to look to.

QUESTION

Except politicians perhaps or governments taking action now?

MR. BOUEY

What action could they take?

QUESTION

Well, going back to the Alsands Plant. Would that kind of massive energy development and getting on to those developments, would that be of assistance to you in terms of regulating the economy?

MR. BOUEY

What are we talking about? I thought we were talking about this very short, this very immediate problem of high interest rates and weak Canadian dollar. That is what I was talking about anyway and I was saying that there is really nothing you can do about that except take part of the pressure on interest rates and part of it on the exchange rate. That is all there is.

QUESTION

What can individual Canadians do to help the Canadian economy?

MR. BOUEY

Stay home, don't go to Florida.

QUESTION

If we are suffering from problems that are not of our own making, that is the volatility of the U.S. interest rates or U.S. policy, do you regard any system or some variant of exchange control as a method of insulating us from this volatility?

MR. BOUEY

No, I do not. That is theoretically possible. But that is the last thing I would recommend. We would have to decide what it was you are to control. You would have to have a tremendous apparatus and I think that when you see interest rates spreads of the kind we have seen, or if you want even wider ones, you will find that even in those countries that do have foreign exchange control, the money will leak through with those kind of incentives.

QUESTION

Mr. Bouey, I was interested in your comments that you had to admire the way the West Germans and the Japanese has adjusted to the world price for oil and I was wondering that whether you feel that your task would be any easier right now if this country had already absorbed the major part of the adjustment we still face in moving toward world prices in oil?

MR. BOUEY

I don't think the actual control of inflation would be easier. I think that is a question that really relates entirely to the subject of energy. In the case of the Japanese and the Germans, they had no choice at all because they haven't got any energy. We do have a choice. But that is a choice that I don't make.

QUESTION

Just a second question, if I can, on the general expectations that the country has. Do you feel that with the longer term difficulties that we

still face in controlling inflation, do you feel that the time has now come that people should realize that they are going to have to accept a lower standard of living in order to deal with that problem?

MR. BOUEY

Well I am not sure that the standard of living that we have to accept is going to be lower. I don't know. It is the case that in recent years, there hasn't been any significant increase in productivity, or output per person employed. Of course that is what produces the increase in the standard of living. I hope we can get back on track fairly soon and see further increases in the standard of living. It may be difficult for a year or two but I don't think that we have to give that up forever.

QUESTION

Will you be lowering your money supply targets soon from the current level?

MR. BOUEY

I think we will see how this immediate problem that comes to us through American interest rates goes before we turn our attention to that. With the kind of interest rates we have now, the money supply is not going to grow too fast. So the question of a target range is not urgent.

END

BANK OF CANADA

BANQUE DU CANADA

press statement

communiqué

OTTAWA
January 16th, 1981

The attached memorandum, which provides a summary of the way in which the Bank of Canada conducts monetary policy, was prepared in response to a request from the Treasury and Civil Service Committee of the United Kingdom House of Commons. In the course of its inquiry into monetary policy that Committee made requests of a number of central banks to provide it with information regarding the conduct of monetary policy in their respective countries.

MEMORANDUM ON MONETARY POLICY PREPARED FOR THE HOUSE OF COMMONS TREASURY AND CIVIL SERVICE COMMITTEE OF THE UNITED KINGDOM

The preamble to the Bank of Canada Act defines the objectives of monetary policy in Canada. The role of the Bank of Canada is "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion".

The Act also confers on the Bank of Canada various technical powers of the kind generally exercised by central banks in the performance of their monetary control function. The Bank of Canada's note and deposit liabilities serve as the ultimate form of cash in the Canadian monetary system. This circumstance gives rise to a demand on the part of the chartered banks for claims on the Bank of Canada as banking reserves and this demand is reinforced by the fact that the banks are required by law to hold minimum average cash reserves against their outstanding deposit liabilities. By varying the amount of reserves in the system the Bank of Canada can affect the desire of the banks to bid for assets or deposits. Thus, for example, by reducing the supply of cash reserves relative to the quantity needed by the system to meet the legal requirement, the Bank of Canada can quickly force at least some of the banks into a position of having to sell off liquid assets or to bid more aggressively for blocks of short-term deposit funds. These portfolio responses by banks will put pressure on the level of short-term interest rates in the domestic money market generally with indirect effects in the same direction spilling over into other areas of Canada's interest rate structure.

The Bank of Canada has always tried to use this influence on interest rates to affect the rate of growth of total spending in the economy in a manner which would contribute to the achievement of the country's economic objectives. Until a few years ago the pursuit of these objectives typically involved actions to smooth cyclical fluctuations in economic activity. Judgments about the appropriate direction and magnitude of the adjustments in short-term interest rates needed for this purpose were based on views about the near-term outlook as well as on a careful monitoring of a number of current economic and financial indicators. The Bank has always shown some interest in movements in the money supply variously defined but until relatively recently it did not have a good basis for obtaining much useful guidance for current policy from these movements.

Making judgments about interest rates on this basis became increasingly difficult during the early 1970s when rising rates of inflation and the development of inflationary expectations made the effects on spending of increases in nominal interest rates much more uncertain. Although interest rates rose quite sharply during this period, inflation pressures continued and there was increasing uneasiness in the Bank about the way policy was working. A considerable amount of research in the Bank at this time was devoted to an analysis of the relationships between monetary aggregates, national expenditure and interest rates to see if a monetary aggregate could be used in a systematic way as a guide for monetary policy.

To be useful in setting interim targets for monetary policy a monetary aggregate should satisfy two principal requirements. First there should be a sufficiently well-established link between the growth in demand by the general public for the money balances which make up the aggregate and the growth in total spending in the economy to permit the central bank to decide with reasonable confidence what growth path for the aggregate is consistent with a particular growth path for total spending. The second requirement is that the growth of the monetary aggregate should be sufficiently sensitive to the actions of the central bank so that monetary targets can be achieved over a reasonable period of time without generating unacceptable instability and uncertainty in financial and foreign exchange markets. Our research indicated that M1, a monetary aggregate comprising currency and demand deposits held by the general public, met these criteria reasonably well. Movements in M1 are a function mainly of changes in national income and in short-term interest rates. Since interest is not paid on holdings of M1 this aggregate is quite sensitive to changes in short-term interest rates and is therefore susceptible to central bank control.

Following on this analysis the Bank of Canada began its present practice of setting interim targets for money growth defined in terms of M1. Over the past five years these targets have been gradually reduced from an initial range of 10 to 15 per cent growth to the present range of 5 to 9 per cent growth. The Bank has used its ability to influence short-term interest rates to keep the trend of monetary growth generally within the target range. The levels of interest rates and the effect of any changes in the margins between domestic and foreign rates on the exchange rate which flow from this policy approach are its cutting edge in exerting an influence on spending decisions and thus on the trend of expenditure in the economy.

Looking back over the period during which targets for M1 have been set, it is the Bank's view that monetary policy has undoubtedly been improved by their use. Nonetheless, there have been problems from time to time with the use of M1 as a guide for the conduct of monetary policy which should be noted. There are random short-term fluctuations in the growth of M1 for which no explanations are found even after the event. While these are rarely so large or so long lasting as to present a problem for policy, occasionally unexplained movements of this kind can take longer to reverse themselves, causing M1 to diverge from its underlying

trend for some months. For this reason the targets for M1 set by the Bank of Canada have been expressed as a range rather than a single growth rate. There is no great significance to the movements of M1 over the course of a few weeks or even a few months; it is the trend over considerably longer periods which is of primary importance.

M1 has also been subject to the effects of a number of institutional changes resulting from innovations in banking practices. The nature of the various measures of the money supply is shaped by the practices of financial institutions. As long as any changes in these practices are relatively minor they give rise to no particular problem in interpreting money supply series. Major changes in banking practices can however cause a problem because it is rarely possible to get a direct measure of their effects on the money supply statistics and so it is difficult to know with any precision what allowance should be made for these effects in interpreting the behaviour of M1 and adjusting the target range from time to time. There have been innovations in Canadian banking practices which have been important in this regard. The resulting shifts between M1 balances and other financial instruments reduce the confidence one can have in the stability of the relationship between M1, national income and interest rates, and mean that one cannot put uncritical reliance on this monetary aggregate as a guide to monetary policy.

The analysis of these problems with the use of M1 has not however indicated that monetary policy could be improved if the Bank of Canada framed its monetary targets in terms of some broader aggregate. There are even more difficult problems in extracting information useful to the conduct of monetary policy in Canada from the broader aggregates. This is because the broad aggregates are affected in a major way by factors other than the growth of national income and changes in interest rates. In the Canadian financial system shifts in the shares of business flowing through banks, other financial institutions and securities markets are constantly occurring and frequently give rise to major movements in the broader aggregates that are without significance for monetary policy. Another limitation to the use of broad monetary aggregates as policy targets in Canada is that these aggregates are relatively unresponsive in the short-run to interest rate movements and, as a result, they cannot be readily controlled by central bank actions.

Given the relative looseness of the relationship between monetary aggregates and the growth of spending in the economy, apart from the effects of interest rate changes, the Bank does not consider that the use of monetary growth targets can be approached in a mechanical way and it continues to analyse a broad range of economic and financial information for policy purposes. Such analysis is clearly necessary both in setting and changing money supply target ranges and in assessing the timing, magnitude and economic impact of short-term interest rate adjustments that the Bank may consider from time to time. Moreover, within the general framework of monetary targets, the Bank continues to have regard

in its operations to any near-term developments on the economic or financial scene that may pose a direct threat to Canada's cost and price performance. Thus, following the depreciation of the external value of the Canadian dollar in 1977 and 1978, the Bank has been paying particular attention to interest rate relationships between Canada and abroad to ensure that they would not contribute to an acceleration of inflation through a further substantial decline in the exchange rate for the Canadian dollar in circumstances where such decline was not needed to make the Canadian economy competitive internationally. While inconsistencies may seem to arise temporarily between this objective and the specific target range for M1, the Bank sees no fundamental conflict between this concern for the potential inflationary effects of exchange rate depreciation and the pursuit of a trend rate of growth of M1 which is over time consistent with receding inflation.

NOT FOR PUBLICATION BEFORE: 1:00 P.M. CENTRAL STANDARD TIME
MAY 6TH, 1981.

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO THE BUSINESS OUTLOOK CONFERENCE
OF THE SASKATCHEWAN CHAMBER OF COMMERCE
MOOSE JAW, SASKATCHEWAN
MAY 6TH, 1981

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the Business Outlook Conference
of The Saskatchewan Chamber of Commerce
Moose Jaw, Saskatchewan
May 6th, 1981

I am particularly pleased to be able to participate in this business outlook conference of The Saskatchewan Chamber of Commerce although I am not going to forecast the path of the economy over the near-term future. It is not my practice to make public economic forecasts and in any event you have others on your programme who are doing that for you. What I do want to talk about is monetary policy, that is, about the control of the money supply and about interest rates, factors which are bound to exert an important influence on the future course of inflation and economic activity in Canada. I will volunteer one forecast, however, which is that interest rates are unlikely to decline significantly until there are some signs of progress being made in reducing the rate of inflation.

In saying that, I am well aware that high interest rates are difficult, even painful, for many of you in carrying on your business activities. I can assure you that the Bank of Canada has no wish to create unnecessary problems for you. My connection with this part of the country is very close and I understand the many difficulties already faced by farmers and businessmen in Saskatchewan, operating in an economy that can be severely buffeted by

the whims of both weather and world markets. At the same time I am very much aware that inflation can also cause a great deal of trouble for you because of its impact on the prices of machinery and equipment and other costs of production. What we at the Bank of Canada wish to see is both a declining rate of inflation and lower interest rates, for it is only with a significant moderation of inflation that it will become possible to have significantly lower interest rates.

Interest rates have just recently risen to record levels. They are even higher than last December's peak levels which at the time seemed so extraordinary that they were then regarded as most unlikely to last for very long. Why has this happened? The main reason is that interest rates have come under further upward pressure from the strength of the credit demands that have been generated in Canada by the combination of a strong rate of growth of output and the worsening of inflation and expectations of inflation. This upward pressure on interest rates has been reinforced by the relatively weak performance of the Canadian dollar relative to the U.S. dollar in the foreign exchange market.

The real growth of the Canadian economy has been surprisingly strong over the past three quarters, much stronger than seems to be generally realized. Indeed there seems to be a widespread but erroneous view abroad in this country that the Canadian economy is severely depressed and barely

growing at all. The truth of the matter is that after growth resumed at a moderate pace in the third quarter of last year, real output surged ahead at an annual rate of more than 8 per cent in the fourth quarter and probably at an annual rate of as much as 4 to 6 per cent in the first quarter of this year. These rates are far above any realistic estimate of the growth of output that can be sustained by the Canadian economy. An important factor in the expansion of economic activity over this period has been the strong performance of the Canadian economy in international trade. Our trade picture reflects a much improved international competitive position as a result of the massive exchange rate adjustment that took place a few years ago. The recent strong rate of real growth in Canada has been coupled with a high and rising rate of price increases. The resulting growth in total spending has been accompanied by a persistently strong demand for credit which in turn has been a major source of continuing upward pressure on Canadian interest rates. The pressure has been reinforced by heavy borrowing to finance real estate acquisitions and corporate takeovers and by the large cash requirements of governments.

The weakness of the Canadian dollar relative to the U.S. dollar in the foreign exchange market has also been a factor in the disposition of Canadian interest rates to rise. The persistence of this weakness must be regarded as disappointing in view of the fact that at least until a few days ago interest rates in Canada have been sufficiently higher than in the United States to be relatively favourable to the inflow of capital into Canada. Moreover, as I

have already indicated, our international trade balance has been much better than in recent years. Yet in spite of these positive factors the Canadian dollar has not recovered very much ground from its low point of late last year. It would seem necessary to look elsewhere for an explanation of why this should be so -- to the view one frequently hears expressed that, because Canadians have so many unresolved internal differences at present, the attractiveness of Canada as a country in which to invest has lost some of its former appeal.

The various forces at work in the Canadian economy that I have just pointed to as reasons for the recent tendency of Canadian interest rates to rise were forces that the Bank of Canada had to take into account in considering to what extent it would be wise to resist the tendency. Let me recapitulate them: the strength of the current economic rebound in Canada; high and rising inflation and serious fears of still worse inflation to come; a continuing strong demand for credit even with interest rates at levels that normally would have discouraged domestic borrowing; and a persistent weakness of the Canadian dollar that was adding to the upward pressures on costs and prices in Canada. In these circumstances there was not a convincing economic case for preventing an upward movement of Canadian interest rates, and no economic case at all for a decline in interest rates. The last thing a country in Canada's present dangerously inflationary situation needs is to step up the process of money creation in a short-sighted attempt to hold down interest rates, one effect of which would be a further decline in the

exchange rate. Anyone who doubts that the inflationary psychology now gripping this country has reached alarming proportions should meditate on the current phenomenon of a booming residential housing market in many of our major cities despite mortgage interest rates of 16 1/2 to 17 per cent a year. We had all better face the fact that this country really does have a very serious inflation problem on its hands.

It may help you to understand why the Bank of Canada has responded to the current situation in the way that I have described if I try to explain in some detail how I view the problem of inflation and the role of the Bank in dealing with it.

Only twenty years ago the rate of inflation in Canada was less than two per cent a year. Over the intervening period inflation in Canada has not only become chronic but has surged ahead repeatedly to reach its present level of around 12 per cent a year. Thus the disease that this country has contracted is not just high inflation, but escalating inflation. Doubts about the ability of this country to rid itself of this cancer of growing inflation have spread throughout our society and are clearly apparent to-day in almost every aspect of our economic behaviour.

I continue to believe, however, that Canada's serious inflation malady can and must be brought under control and eventually cured. I also believe that whatever else needs to be done to effect a cure, the key element must be the restoration of a greater degree of realism, responsibility and continuing discipline in public financial policy than we have had for

many years and the acceptance of that discipline by the general public. Price and cost pressures cannot be contained in an economy in which the over-all level of spending is repeatedly fed increasing doses of fiscal and monetary stimulus, with only belated and short-lived attempts to cut back on the dosage when the economy begins to overheat and the rate of inflation to spurt ahead. We will never master inflation so long as we insist on trying to keep the Canadian economy operating at levels of capacity utilization and labour market tightness that are manifestly incompatible with moderation of the trend of price and cost increases.

The Bank's approach to monetary policy follows directly from this view of Canada's inflation problem and what needs to be done to overcome it. The policy is based on two fundamental propositions, both of which I regard as unassailable.

Proposition I is that Canada has no option but to contain and reduce inflation. Quite apart from the obvious unfairness of inflation and its progressively debilitating effects over time on the ability of the economy to function effectively, any attempt to tolerate it will simply make matters worse. Experience around the world has shown that in the end inflation is always resisted: the only questions are at what stage and how. The higher the rate of inflation is allowed to go before the battle is undertaken seriously, the more painful and arbitrary the measures to combat it tend to bec

Proposition II is that whatever else is done to control inflation, it will never in fact be controlled unless the growth of the money supply is kept within prudent limits. And that is our job. I hasten to add that we have never claimed that firm control of the money supply is all that is required to bring down inflation and at the same time ensure good economic performance. But it is a necessary part of any effective economic policy directed towards those objectives.

I might note in passing that the idea that inflation cannot be controlled if growth in the money supply continues to be excessive is not a new one by any means. In fact as economic propositions go it is a very old idea. In recent years we have adopted the practice of establishing target limits for monetary growth but that is a matter of technique and it does not turn this long-held, basic proposition into some new-fangled economic theory.

In spite of our emphasis on the control of the money supply when we talk about monetary policy, it is natural for people to look at monetary policy in terms of interest rates instead. I have yet to hear of a potential borrower going into his bank and asking how the money supply is doing before he discusses a loan and the rate of interest on it. And neither, of course, do we expect him to. The difference in focus between ourselves and the individual borrower or lender comes about because of our responsibility for over-all monetary management. If we are going to

limit monetary expansion we cannot afford to have any strong preconceptions about where interest rates should go. Certainly the actions we take in financial markets for the purposes of containing monetary expansion do have an effect on interest rates, but when all the dust has settled what actually happens to interest rates is the joint outcome of these effects and all the forces at work in the economy that are affecting the demand for money and credit.

Over the past six months the rate of monetary expansion in Canada, though considerably lower than in recent years, would still have been more than enough to accommodate considerable real economic growth with much lower interest rates than those we now have -- but only if the price level had been rising much more slowly. The reason interest rates are now as high as they are is primarily because inflation has greatly increased the demand for money and credit. Indeed by far the largest component of the present level of interest rates is the inflation premium, by which I mean the additional interest required by savers in order to compensate them for purchasing power they stand to lose as a result of inflation. The remaining component of the interest paid by borrowers and received by savers -- the amount by which the interest rate exceeds the expected rate of inflation -- is often called the "real" interest rate.

For most of the past decade interest rates were unusually low in relation to the inflation rate and savers did not get a sufficient return to compensate them for the loss of purchasing power caused by inflation. At the same time the cost of credit to borrowers, particularly on an after-tax basis, frequently turned out to have been exceedingly low in real terms since debts were being repaid with much cheaper dollars. In these circumstances inflation tended to worsen.

Monetary policy has now become firmly anti-inflationary. The target that we set for the money supply (defined for this purpose as currency and demand deposits at banks) has recently been lowered to an annual rate of growth of 4 to 8 per cent. This will help to ensure that interest rates are at levels capable of exerting a moderating influence on the rate of growth of total spending, and thereby on the rate of increase of prices and costs.

There would be more support for a policy of monetary restraint if the role of interest rates were better understood than it is now. A popular view is that a rise in interest rates is itself a cause of inflation because it adds to the costs that borrowers incur in doing business. That interest rates have some effects in this direction cannot be denied, but this is far from being the most important part of the story. If it were, you could push the argument to the absurd conclusion that the way to bring down inflation would be to have zero interest rates, absolutely free money. The role of rising interest rates in limiting inflation is quite opposite to their effects on costs. For one thing, they help to maintain an adequate value for the

Canadian dollar and thus keep down the Canadian dollar equivalent of prices that are determined outside our country. The major impact, however, comes from the fact that interest rates affect total spending in the economy. Interest rates have to be sufficiently high to keep the demand in markets for goods and services from being too buoyant so that market discipline is strong enough to make it difficult to raise prices and costs rapidly without suffering losses of sales and employment.

If we are to control inflation we must return to this kind of market discipline. It is what we relied on in past periods of price and cost stability. As we move toward the restoration of that kind of market discipline interest rates can decline. That is the objective of the Bank of Canada -- declining rates of inflation and declining interest rates. Only then will there exist a basis for the kind of economic performance this country is capable of achieving.

Let me say in conclusion that it would be foolish to ignore the fact that Canada is face to face with a very serious problem of inflation. It would be equally foolish to suppose that a painless solution is available, or that procrastination will help. The sooner the country faces the facts the better. Firm and continuing restraint on the rate of monetary expansion is one essential element in the cure. Whatever the other elements may be there can be no serious debate about the essentiality of the monetary element. Since that element is the Bank of Canada's responsibility our duty is clear.

NOT FOR PUBLICATION BEFORE: 1:30 P.M. EASTERN DAYLIGHT SAVING TIME
MAY 26TH, 1981

STATEMENT PREPARED FOR THE APPEARANCE OF

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

BEFORE THE

STANDING SENATE COMMITTEE

ON NATIONAL FINANCE

TUESDAY, MAY 26th, 1981

Statement prepared for the appearance of Gerald K. Bouey, Governor of the Bank of Canada, before the Standing Senate Committee on National Finance, Tuesday, May 26th, 1981.

In the last year or so I have said so much about what the Bank of Canada has been doing that I doubt that there is much need for me to say anything on that score to the Committee at this time. My last Annual Report, published in March, reviewed the rather dramatic events of 1980, and in a speech on May 6th delivered in Moose Jaw I brought the story up to date, with particular attention to current economic developments. In addition, my colleagues in the Bank and I have made many statements to the press or to others on the role of monetary policy in the present circumstances.

Events this month have once again given the activities of the Bank a high profile. There has been a lot of discussion of our actions -- which we welcome -- and a good deal of confusion about them -- which we regret. I hope that the proceedings here today can help to clarify some of the matters at issue. I would like to make some opening remarks on two of the most basic questions, namely,

(1) how much concern is warranted by the current trend of inflation in Canada? and (2) if serious concern is warranted, what can be done about it?

How Much Concern about Inflation is Warranted

There are a number of measures of the rate of inflation, but if one considers them he will I think be forced to conclude that the current rate of inflation in Canada must be put at above 10 per cent per year, at say 11 or 12 per cent. He will also observe that the rate of inflation in Canada has been rising over the past few years and that it appears to be continuing to rise. He will probably also agree that, insofar as it is possible to generalize about people's expectations for the next year or so, they seem to be that the rate of inflation is more likely to rise than fall. Finally, he will probably agree that the current rate of inflation is somewhat higher in Canada than in the United States, and that it is generally regarded as more likely to rise here than there.

The Canadian dollar has been weak vis-à-vis the U.S. dollar and further significant weakness would add to inflation in Canada.

What should one think about this state of affairs? Everyone who is interested in my views knows that I think it warrants grave concern. The reason for my concern is the effect of inflation

n the future performance of the Canadian economy. It is a concern ooted in the welfare of Canadians. I do not think it is realistic o suppose that an economy like ours will work well under conditions f rising inflation. Rising inflation is a recipe for stagnation not or prosperity. My dispute with people who disagree with that view s not about ends -- I am as deeply concerned for the future welfare f Canadians as they are. The dispute is about means. I am sure hat failure to face up to the problem of inflation will compound our conomic problems and increase the economic pain involved in esolving them.

You are of course aware of those people who say, "Yes, of ourse we must deal with inflation but first let somebody devise a ainless way of doing it". Until that happens, they sometimes add, he cure is worse than the disease. Painless cures are a nice idea ut people who hope to find a painless cure for inflation know little bout the disease. They are dreaming pleasant dreams and it is too ad to have to try to wake them up.

Then there are others who say that it will be easier to earn to live with inflation than arrest it. What do these people hink is involved in living with inflation? Do they assume that the resent inflation rate would stabilize if public policy turned to earning to live with inflation? What could be more unlikely! othing stimulates inflation like indifference to it. History

affords us examples of societies that have seemed to try to learn to live with inflation, but at some rate of inflation -- 20 per cent, or 100 per cent, or in a few cases 1,000 per cent or more -- they have had to give up and start the long hard road back. In a number of cases democratic government was a casualty of the process.

Being relaxed about inflation simply will not work. Sooner or later a society has to grapple with the erosion in the value of its money. What are the means available to do that?

In a free society many elements of public economic policy have, or can have, a bearing on the trend in the value of money, that is, on the rate of inflation. There are the two so-called "big levers" for influencing the level of total money demand -- fiscal and monetary policy. Then there are a host of more specific policies affecting the way that individuals, businesses, trade unions and others operate in markets. These can be called supply policies or competition policies or micro policies or regulatory policies and they include what is involved in terms like industrial strategy, industrial relations policy, income maintenance policy, regional policy or sectoral policies like transportation policy or energy policy. Finally there are the various direct controls like wage and price control and credit control. How an economy operates over time and what happens to the purchasing power of its money are affected by the interaction of all of these policies. Let me say a little about how some of these policies affect the outcome.

1. Monetary policy is the task of the Bank of Canada, and I accept responsibility for it. That makes it easier for me to talk about it. The other policies are the direct responsibility of the Government of Canada or the provincial governments, and insofar as I have advice to offer to the Government on those policies it is my practice to give it in private.

Monetary policy has basically to do with the rate of monetary expansion however defined. The rates of interest that exist from time to time are the results of the interplay between the rate of monetary expansion and the demand for money and credit generated by the activity in the economy. The way that the Bank of Canada influences interest rates is by varying the rate of monetary expansion.

In respect of the influence of monetary policy on the rate of inflation, the central point is that if the Bank of Canada permits more monetary expansion than the economy needs to operate at a reasonably high level with price stability prices will rise. There will be inflation. This is what has happened for many years. In that sense the Bank has accommodated inflation. But for some years now the Bank has been reducing gradually the trend rate of monetary expansion. This is essential if the rate of inflation is to decline. This is the proper contribution of monetary policy to anti-inflation policy. It is essential, and it is being provided. The Bank intends to continue providing it.

The current high levels of short-term interest rates are the fall-out from the interaction of this monetary restraint and the very high current demand for money and credit in the economy associated with the relatively high levels of economic activity and the high rate of inflation and expectations of inflation. A distressing number of people appear to believe that these interest rates are working on balance to raise the rate of inflation rather than to lower it. This proposition, we are told, is common sense because interest costs are an element in production costs. But this proposition will not stand critical examination any better than the common-sense proposition that the world is flat because it looks flat. What an individual first sees in both cases is not the true story. High interest rates operate to reduce total spending in the economy from what it would otherwise have been, and this eases the upward pressure on prices from what it would otherwise have been. No proposition in economics is more certain than that a move of the Bank to allowing significantly higher rates of monetary expansion in an effort to lower short-term interest rates would increase the rate of inflation. This would in turn feed back in a little time to generate higher interest rates. That policy would be a prescription for surrendering to inflation, high interest rates, and economic stagnation.

It is true that high interest rates can have a quite uneven impact across the economy on different groups of individuals,

different industries and different businesses within an industry. If inflation is to be subdued with a minimum of stress it is therefore desirable that other public economic policies also have an anti-inflationary thrust.

2. Fiscal policy, like monetary policy has an important influence on the rate of increase in total spending in the economy. There can be no doubt that in our present inflationary difficulties, with demand in the economy running as strongly as it is and with expectations of inflation so intense, the extent to which governments engage in deficit finance must be a major policy consideration. From the viewpoint of moderating the demand for goods and labour and the pressure of borrowing requirements on financial markets it is the case that the smaller the deficit the less strained the situation will be. On those grounds I have welcomed the recognition by the Government of Canada of the need to reduce its deficit over time.

Over the long run the case for limiting deficit financing depends on one's view of the degree to which national economic welfare is served by governments diverting private savings from the capital markets to support government activities. The merits of channelling savings to finance government depend fundamentally on the value that is placed on the use government makes of the savings as opposed to how they would have been used otherwise.

I have discussed the position of the government sector in terms of its deficit, not in terms of its over-all size as measured by its total outlays. This is because I have taken the view that Canadians can have as large a public sector as they are willing to pay the taxes to support. I would add one caveat, however. It is essential that taxpayers really be prepared to pay the costs of governments including transfer payments -- that is that they be willing to forego the real income that might otherwise have been available to them and not seek compensation for increased tax bills by demanding larger increases in money incomes than are possible without generating inflation.

Before I leave fiscal policy there is one issue I want to clear away and that is whether Government deficits are financed by "printing money". In Canada they are not. The goals of monetary policy are set independently of whatever size the Government's borrowing requirements happen to be. Thus the public debt is financed in the market at market interest rates, and the Bank of Canada participates in that market only to the extent that its money supply policy permits. Increases in Government borrowing requirements have much the same effect on the level of interest rates as increases in private borrowing.

3. Other policies. My comments on other types of government policies that can operate in an anti-inflationary direction will be

very brief, not because they are not important but because they are far outside my area of responsibility. One set often mentioned these days involves the pursuit of policies to deregulate and decontrol markets in the interests of a more productive and efficient economy. I have nothing specific to say about this approach except that I think the broad public interest lies in taking a skeptical view of the value of restraints on the functioning of markets and on the rate of supply of particular goods or services. This would be true even if inflation were not a problem but it is doubly so given our difficulties. I can be still briefer regarding another approach, that of direct controls. Some forms of temporary controls can sometimes be useful in circumstances where events have got out-of-hand but they are not a substitute for sound financial policies.

Some people might add to the above list of public policies that have, or can have, an effect on the purchasing power of Canadian money what is sometimes called exchange-rate policy. I am not inclined to do so for when a country's foreign exchange rate is floating as it is in Canada that rate is affected by all the other policies, that is, by the total circumstances of the economy relative to other economies. It can be influenced by a change in monetary policy or fiscal policy or regulatory policy or by direct controls. If, for whatever reason -- by rising external interest rates, for example -- forces operating in the exchange market threaten to

depress the exchange rate when that is not needed to preserve a reasonably competitive position for the country's international trade and when it would add to the upward pressure on prices internally, effective anti-inflationary policy would seek for some policy adjustment to neutralize the threat. That adjustment could be in monetary policy, which through interest rates can have an immediate impact on capital flows, but in some circumstances it could also be partly in debt management policy, or fiscal policy, or in regulatory policy.

4. Bank of Canada responsibility. Looking over the current situation one could say, if one wanted, that it would be nice if events in the United States had evolved differently and the Americans were not now experiencing such high and volatile interest rates. One could add, if one wanted, that it would be nice if things had evolved differently here in various ways. However, saying what would be nice doesn't get you very far. It is always necessary to look forward, to focus on what can in fact be done in the light of the conditions that prevail.

The Bank of Canada's responsibility lies in the monetary field and what it has to work with is the control of the money supply, not the tools of fiscal policy, regulation, or direct controls. The Bank has to use its powers in the world as it finds it, and to face up squarely to the implications of what it finds there for the integrity of the nation's money. In present circumstances there is no good reason for avoiding a monetary policy that provides strong resistance to inflation.

NOT FOR PUBLICATION BEFORE: 12:45 P.M. IN CALGARY 2:45 P.M. IN OTTAWA
SEPTEMBER 23, 1981

REMARKS BY

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

TO THE

MEN'S AND WOMEN'S CANADIAN CLUBS

OF CALGARY, ALBERTA

SEPTEMBER 23RD, 1981

Remarks by Gerald K. Bouey
Governor of the Bank of Canada
to the
Men's and Women's Canadian Clubs
of Calgary, Alberta
September 23rd, 1981

Today I want to talk mainly about interest rates.

Interest rates are extremely high. They are much higher than I ever expected to see them. They are causing a great deal of stress and strain in this country among home owners, farmers, small businessmen and others. I hear about these problems in very specific detail every day through telephone calls, letters, visits, the media and contacts with financial institutions. I assure you that there is no lack of awareness in the Bank of Canada of the difficulties caused by high interest rates. Lack of awareness is not the problem. The problem is what the Bank of Canada can do about the situation that will not in the end do more harm than good.

Before one comes to a conclusion on that question it is useful to reflect on the factors that have contributed to the extraordinary rise in interest rates in Canada.

The main contributor to the present level of interest rates in Canada is the rate of inflation that exists

and that is expected in Canada. Inflation of costs and prices increases the amount of money that people need to borrow, and expectations of rising inflation increase their willingness to borrow it. Unless the Bank of Canada is prepared to accommodate whatever rate of inflation turns up, no matter how high, it must keep the rate of money creation under control. The interaction of the strong spending pressures and the strong demand for money on the one hand and restraint on the growth in the money supply on the other is what has caused short-term interest rates to rise.

With inflation as high as it is interest rates are bound to be high. How high? Well, certainly well above the inflation rate. You may recall what interest rates were like in earlier periods when we had no inflation. In those post-war years when inflation was very low or zero, when the general fear or expectation was of a reversion to the depression era rather than rising inflation, and when fiscal policy was relatively strong, the prime lending rates of banks were generally in the 4 1/2 to 5 1/2 per cent range while mortgage rates were somewhat higher. These were "real" interest rates in the sense that virtually no allowance had to be made for inflation or expected inflation. For anything like the same "real" interest rates now, you have to have interest rate levels well above the current and expected rate of inflation. I do not want to be at all precise about how much above for there are other factors

that must also be taken into consideration. But I think you can see that until progress can be made in bringing inflation down in Canada, interest rates will have to be high in this country. They will fluctuate around a high level. That would be true even if we were not living in a world in which interest rates, particularly in the United States, are now very high.

But we are attached to the rest of the world. Money is free to flow in and out across our borders in response to interest rates and other incentives. This does not mean that our interest rates must move exactly like U.S. interest rates. Over the past eighteen months our short-term interest rates have sometimes been 4 per cent lower than theirs and sometimes, as in recent months, as much as 4 per cent higher. But it does mean that the level of interest rates in the United States has an important influence on the situation here.

There are a number of reasons why our interest rates are now higher than American rates. Canada normally runs a deficit on current account in its international payments and we must attract enough foreign capital to cover that deficit. This year that deficit has been growing. Our problems in this area have been exacerbated by the dispute over energy prices which, while it lasted, increased the need for imported oil and had some adverse effect on capital movements as well. On top of that an additional burden has been placed on our balance of

payments, at least in the short and medium terms, by the unusual scale of takeovers of foreign companies operating in Canada that have occurred this year. In the last several months takeover activity has had a major influence on both the exchange rate and the level of interest rates.

There is one more important element in the difference between Canadian and U.S. interest rates. If the rate of current and expected inflation were appreciably lower in Canada than in the United States interest rates here could be no higher, perhaps even lower, than in the United States despite our balance of payments situation. But the current and expected rate of inflation is higher in Canada than the United States and this tends to increase the difference between interest rates in the two countries.

As a result of all the factors I have mentioned -- our serious made-in-Canada inflation, our current account deficit and other special factors that increased the need for an inflow of capital -- interest rates have risen well above those in the United States. A few weeks ago the prime lending rate of Canadian banks reached a peak of 22 3/4 per cent compared with 20 1/2 per cent in the United States. Some money market rates were more than 4 per cent higher than in the United States. I am glad to be able to add that interest rates in both countries have come down a little in very recent weeks.

What in these circumstances were the alternatives for monetary policy? What would have happened if, in spite of our own serious inflation problem and our balance-of-payments difficulties, we had tried to keep our short-term interest rates significantly lower by increasing the rate of monetary expansion? One immediate result would have been a sharp fall in the exchange value of the Canadian dollar. One cannot tell with any assurance how far the Canadian dollar would have dropped, but if the authorities of a country experiencing marked domestic inflationary pressures fail to offer resistance to a decline in that country's foreign exchange rate you can be sure that the decline will be large. Past experience would indicate that in the end the market, with confidence seriously damaged, would have pushed the rate to the point where the authorities would have been forced to react strongly, and the reaction would likely have involved interest rates that were higher than ever.

In the circumstances that existed there would have been no worthwhile benefit from a significantly lower exchange rate. Canada was already competitive internationally because we had already had so much exchange depreciation, and further exchange depreciation would in the circumstances have fed through quickly to increasing the rate of price and cost inflation in Canada. Do not be misled by estimates that one sees from time to time that a fall of 1 per cent in the exchange value of the Canadian dollar results in only a 0.3 per cent

increase in our prices. That is an estimate of the first round automatic increase that results from the effect on the general price level of the increase in Canadian dollar prices of internationally-traded goods. But in a highly inflationary environment there is no reason to believe the increase would stop there: it would spread through the economy as one group after another attempted to obtain compensation for these cost increases. That is why in the present world environment we see every industrial country trying to avoid or limit exchange rate depreciation. Exchange rate depreciation is not part of a solution to our problems. It is itself inflationary, and inflationary solutions to inflation do not exist. In our situation the last thing we should want is a prolonged slide in the foreign exchange value of the Canadian dollar.

I think I have said enough to demonstrate that it is wrong to suppose that our interest rate difficulties have come mainly from abroad. While we cannot avoid being influenced by U.S. interest rates, given our inflation and our balance-of-payments difficulties it must be conceded that our present interest rates have a large made-in-Canada content.

For the reasons I have outlined the Bank of Canada has in recent months given a high priority to the exchange rate situation in its monetary policy operations. The move to higher interest rates was not triggered by an excessive expansion of

the money supply by the measure to which the Bank has paid particular attention -- M1, or currency and demand deposits at chartered banks. If one tries to see through the distortion of M1 caused by the post office strike, it seems for the time being to be running under the lower boundary of the current targeted rate of increase of 4 to 8 per cent a year. Experience has shown, however, that it is wise to be fore-handed in controlling monetary expansion; that it is better to resist strong downward pressures on the exchange value of the Canadian dollar at the time they are taking place rather than wait until the money supply begins to be affected by the price increases that follow a sharp fall in the dollar.

What I have been aiming to do in my remarks to this point is to explain why interest rates have risen to such high levels. In doing this I am not intending to suggest that the situation we are now in is satisfactory. It is profoundly unsatisfactory.

How are we to move to a situation where the general level of interest rates can be significantly lower? I propose to say a few words about each of the factors that have contributed to the present situation -- our own domestic inflation, U.S. interest rates and the spread or margin that has been required above U.S. interest rates -- but in the reverse order.

First the margin above U.S. interest rates. Some steps have been taken recently that should help us. One of them was the request made of banks by the Minister of Finance to reduce their lending to finance takeovers that involve outflows of capital funds from Canada now or later on. This was a welcome move in the circumstances I have described and whether because of it or not the rate of such takeover financing appears to have slackened. More recently, the agreement reached by the Government of Canada and the Government of Alberta on energy pricing and taxation has done much to clear away the uncertainty that existed on the direction Canada might take in this area, and the elimination of the earlier oil production cutbacks will be a tangible benefit to our trade performance over the near term. On the other hand, we continue to have a large current account deficit in our balance of international payments, we continue to encourage some further Canadianization of oil and gas resources, and we have a higher rate of inflation in Canada than in the United States. In those circumstances we cannot reasonably expect to escape having higher interest rates in Canada than in the United States.

I shall not try to predict the future of interest rates in the United States. Financial markets in that country seem to have taken the view that much depends on how large the fiscal deficit of the U.S. government will turn out to be. What Canadians should worry about, I believe, is the possibility that

even if U.S. inflation is brought under better control, and there are some signs of that happening, and if then U.S. interest rates decline, we will not be able to take full advantage of that development because of failure to control our own inflation.

As I indicated at the beginning of my talk our own inflation is the fundamental cause of our high interest rates. What this means is that although Canadian interest rates have declined over the last three weeks, the room for further downward adjustments in the present general level of interest rates will not be great until there are clear prospects of a significant decline in the rate of inflation in Canada. To believe otherwise would be wishful thinking.

I have emphasized that an attempt to bring down interest rates through a rapid expansion of the money supply cannot contribute to a solution of our economic problems and I want now to give equal emphasis to the fact that many policies other than monetary policy can have an important influence on reducing interest rates because they can contribute to reducing inflation. I am pleased to see growing evidence that both these points are well understood by many Canadians.

Policies and practices in other fields should certainly be reviewed to see if they could not be modified in

the direction of generating lesser inflationary pressures and lower interest rates. However, I occasionally come across a version of this view that puzzles me greatly. It is the argument that the first thing to do is to have a sufficiently rapid acceleration in monetary expansion to reduce interest rates appreciably and only then to look around to see what other things can be done to prevent an acceleration of inflation. If the advocates of that argument are really concerned about inflation the questions for them are -- what other things have they in mind? and, why not proceed with them before changing monetary policy? To the extent that other initiatives are effectively anti-inflationary they will reduce the upward pressure on interest rates without any change in monetary policy, that is, without a move to rapid monetary expansion. Surely the sensible way to proceed is to get on with them. Monetary policy claims no monopoly in the fight against inflation, but it is anti-inflationary in a situation which cries out for anti-inflationary policies. Why weaken it before something better is in place? If there has been excessive reliance on monetary policy to contain inflation the thing to do is to improve the balance by strengthening the other components. To proceed otherwise is to put the cart before the horse.

Of course policies other than monetary policy matter in the pursuit of economic prosperity with stability and

I welcome enthusiastically all efforts to explore the contributions they can make. I have referred to these other policies myself on a number of occasions in the past. The Minister of Finance, as the time for another budget draws near, has made it clear that he is concerned about the contribution fiscal policy can make. But the list of such other policies is much longer than just fiscal policy. It includes all the policies and practices of governments, of business, of marketing associations and of trade unions that affect economic efficiency and the flexibility and responsiveness of the economy to changes in the economic environment. The better these policies and practices are the better will be our economic prospects and the less we will be burdened by high interest rates. But insofar as they are inflationary there is no effective way of offsetting this by more monetary expansion.

Since the battle against high interest rates is inescapably the battle against inflation, it is heartening that the current situation is giving rise to so much interest in the various ways in which the resistance of the Canadian economy to inflation could be strengthened through public policy. I have never accepted the idea that Canadians should have to tolerate as their lot a drift into ever increasing inflation, and I am glad to be reassured that most Canadians feel the same way.

My responsibility in all of this is to try to ensure that monetary policy makes the most constructive contribution possible to the resolution of our national economic problems and to explain the nature of that contribution. I make no apology for repeating over and over again that good monetary policy is a necessary condition for good economic performance but it is not a sufficient condition. In the present economic circumstances the consequences of good monetary policy are high interest rates. I am not at all happy about that, but my unhappiness does not alter the facts. Few will be more relieved than I when the circumstances warrant a much lower level of interest rates in Canada. But the Bank of Canada cannot by itself create those circumstances and at the same time ensure good economic performance. That will take a lot of co-operative action by a lot of people. The sooner that is recognized the sooner it will happen. Since I believe that understanding of these matters is growing, I can conclude these remarks on an optimistic note.

NOT FOR PUBLICATION BEFORE: 1:15 P.M. EASTERN STANDARD TIME
DECEMBER 1ST, 1981

REMARKS BY

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

TO

THE MONTREAL CHAMBER OF COMMERCE

MONTREAL, QUEBEC

DECEMBER 1ST, 1981

Remarks by Gerald K. Bouey
Governor of the Bank of Canada
to the Montreal Chamber of Commerce
Montreal, Quebec
December 1st, 1981

I am particularly pleased to have this opportunity to speak to you today because the economic situation has changed and there are a number of things I want to say about this in relation to the monetary policy we are following in this country.

After growing quite strongly for a number of quarters the economy is now in a weaker phase. A similar trend is observable in the United States. In the world economy generally the trend of economic activity is not strong.

The first thing that I want to say about this development is that it does not mean that we should stop worrying about our underlying problem of high inflation and concern ourselves solely with the immediate problem of unsatisfactory economic growth over the near-term. Inflation and growth are much too closely inter-related for that. Continuing inflation progressively damages our longer-run production and employment prospects, and since the battle against inflation is the battle for sustainable growth it must be continued.

The second thing that I want to say about current economic developments is that while spending pressures have eased in many areas of the economy this has not yet been reflected in any significant decline in the over-all rate of inflation, which has recently been almost 13 per cent, but rather in a falling off in the rate of growth in sales and output. This outcome is unfortunately typical of the way that market economies respond in the first instance to the slackening pace of total spending. It would be nice if this were not so. It would be far better if a moderation in the rate of current dollar spending in the economy led almost immediately to a similar moderation in the size of price and cost increases so that output and employment were little affected. But that is not the way it is.

So we must accept the fact that the initial response to a weakening of markets in many sectors of the economy is a cut-back in production. Some businesses continue for a time to push up prices at much the same rate as before even though this means that they are in effect pricing themselves out of the market. Some labour groups continue to press for relatively large wage increases even though this means that they are pricing many of their members out of jobs. It is only with a time lag that the adjustment to less buoyant markets for output and labour moderates the rise in costs and prices. There is no point in pretending that a difficult period of

transition can be entirely avoided if inflation is to be brought under control through policies of financial restraint that exert their influence through market forces. The possibility of countering this difficulty by direct controls, by detailed government intervention in the setting of prices and incomes, raises a whole host of other problems.

In directing monetary policy toward helping to reverse the drift into accelerating inflation the Bank of Canada has been greatly concerned with causing as little disruption as possible to the growth of employment and output during the transition. That is why the Bank set about moderating the rate of monetary growth in a gradual fashion. In 1975, following a period of rapid monetary expansion, the target range for the growth of the money supply, as measured by currency and demand deposits (M1), was set at 10 to 15 per cent a year and was then very gradually reduced over the following five years to 8 to 12 per cent, 7 to 11 per cent, 6 to 10 per cent, 5 to 9 per cent and 4 to 8 per cent, where it is now.

This policy was designed to accommodate continuing economic expansion so long as there was some decline in the rate of inflation. No more than gradual progress was expected. The policy was based on the fundamental proposition that whatever else might need to be done to bring inflation under control it was absolutely essential to keep the rate of monetary expansion

within moderate limits. It was made clear from the start that the Bank was not prepared to allow the money supply to increase to the point where it would accommodate whatever rate of inflation turned up, no matter how high. In practice this meant that if high inflation continued it would push interest rates up to levels that would put downward pressure on inflation by curtailing the growth of total spending in the economy.

It is a matter of regret that this policy was not accompanied in recent years by a reduction in inflation. There are a number of reasons why things did not turn out that way. One of them is that for a time the implementation of the monetary policy was perhaps overly cautious, overly concerned with the risk of adversely affecting the growth of output in the near term. Other reasons that I regard as very important include the sharp rise in energy costs, the puzzling slowdown in productivity, and the upward pressure on prices from external inflation reinforced by the devaluation of the Canadian dollar from over 100 U.S. cents to around 83 U.S. cents. There is also the fact that many other aspects of public policy in Canada were not as anti-inflationary as would have been desirable.

One very serious consequence of this history is that it has generated deeply-ingrained expectations of high and rising rates of inflation. Such expectations were strengthened

as they were validated; betting on inflation paid off. Expectations of future inflation in turn reinforced the inflationary process. That is why inflation was so resistant for so long to the higher and higher interest rates that accompanied the gradual moderation of the rate of monetary expansion. At mortgage interest rates of 16 per cent, for example, house prices continued to be bid up to extraordinary levels. Large companies continued to buy up other large companies, often financing the transactions at interest rates that were very high by historical standards. The expansion of credit, even with extremely high interest rates, continued to be extraordinary. Another example of the inflationary effects of expectations of future inflation was that in many cases employees demanded and employers granted increases in rates of pay that could not possibly be viable at current trends of productivity unless still higher inflation floated them off.

Within a context of monetary restraint this inflationary process in Canada, and one very like it in the United States, drove interest rates to extremely high levels. The peak in short-term interest rates was reached in early August. At that time the Bank of Canada found itself with only unpleasant options available to it. On the one hand, significantly lower interest rates would have been accompanied by a sharp fall in the exchange value of the Canadian dollar, which would in the circumstances have added to inflationary

pressures and would have further strengthened expectations of future inflation. Even at the peak level of short-term interest rates -- 22 3/4 per cent in the case of the prime lending rates for banks -- the Canadian dollar had fallen below 80 1/2 U.S. cents. It would of course have fallen considerably further if strong resistance had not been provided. On the other hand, we in the Bank of Canada knew very well that interest rates had reached a point where they were causing great difficulties for many Canadians. We don't like high interest rates, and we don't want them to be any higher than the country's longer term economic interest seems to require.

Since that time interest rates have been declining and short-term rates are now roughly 6 percentage points below their peak level. Total spending in the economy has moderated greatly and the money supply is now low relative to the Bank's target range, even after allowing for some shifts out of M1 that have occurred as a result of changes in institutional practices. Interest rates have also fallen in the United States and this has made it possible for the decline in Canadian interest rates to occur without causing weakness in the Canadian dollar. A recovery of the Canadian dollar from its low point was helped not only by a wider spread between interest rates in the two countries but also by the energy pricing agreements and the request of the Minister of Finance to the banks to limit takeover financing.

Even with the substantial decline in interest rates that has occurred since August they still look high in relation to past levels. On the matter of the current level of interest rates I want to say two things. One is that interest rates are no longer extremely high when set against the current very high rate of inflation in Canada. The other is that the fairly common comparison of Canadian interest rates with rates in the United States, and the argument that our rates should be pushed down to the levels prevailing across the border, takes no account of the fact that inflation in Canada is now significantly higher than in that country. Our wage increases are considerably higher than those in the United States and the margin of difference has been widening. Indeed the possibility of a further worsening of our inflation rate relative to that of the United States is a matter of real concern.

There is of course a great deal of unhappiness and anger over high interest rates. Some of this anger is directed at banks and other financial institutions. This is unwarranted because these institutions are not responsible for the general level of interest rates. They run their business on the spread between what they pay for money and what they charge for it in competition with one another. Any conceivable compression of this fluctuating spread would have a rather minor effect on borrowing rates.

The orientation of public policy towards fighting inflation is not new in history but what is new in the latest episode is the major role that interest rates have played, not only in Canada but in other countries as well. One reason for this has been a more explicit determination in many countries to keep monetary expansion under control. The great inflationary surge in the early seventies was associated with very high rates of monetary expansion in many countries, and the obvious lessons have been drawn from that experience. This is good as far as it goes but, as I have often pointed out, avoiding excessive monetary expansion is not a sufficient condition for good economic performance; fiscal and other economic policies are also very important. A good mix of monetary, fiscal and other economic policies can fight inflation without as much upward pressure on interest rates as would otherwise be required. The recent budget of the Minister of Finance was directed toward achieving a better balance in this regard.

The problem of securing the most effective mix of policies is not one that is peculiar to Canada. In the United States and other countries the combination of monetary restraint with large fiscal deficits in an inflationary environment also produced very high interest rates. The policy imbalance in the United States has not been more extreme than that of a number of other countries but it has had far more important repercussions around the world because of the importance of the United States

in the world economy. I think that it is difficult for Canadians to complain a great deal about U.S. economic policies because our own mix of policies has often been less balanced than would have been desirable.

Recent experience has shown that when interest rates are allowed to rise to high levels they do slow down the pace of spending. The recent demonstration that betting on inflation with borrowed money is not a sure thing must be regarded as constructive. Moreover, savers have received something nearer to a reasonable reward for their savings than they have for many years. I would, however, hope that we have learned from recent experience in Canada and in other countries that leaning so heavily on monetary policy and interest rates to fight against inflation causes great difficulties in that it puts the burden of adjustment so much on particular groups in the society.

I see no satisfactory way of resolving many of the difficulties that various groups in the economy are experiencing except by getting the rate of inflation of prices and incomes down a lot and keeping it down. Only then will it become a practical possibility to have rates of interest as low as almost everybody wants them to be. It is sometimes pointed out that mortgage interest rates were once generally no higher than 6 per cent but if you remember those days you will also remember that

at that time there was virtually no inflation. The economy will have to go through a major adjustment before anything like that can happen again.

How smoothly or roughly the transition to lower inflation goes will depend on how flexibly price and wage setting behaviour adjusts to the less buoyant and more competitive market environment into which we have moved.

The current environment is no longer conducive to a continuation of rapid inflation. There is now a real risk that large price and cost increases will boomerang on those who try to force them because there are no longer so many eager buyers willing to pay inflated prices. Inflated costs cannot be passed on so readily. That is the market discipline for containing inflation that we have always been able to rely on in our free economic system. That is the discipline that we shall have to continue to rely on if we want to enjoy the great economic benefits that come from a flexible and dynamic economy.

I have already referred to some reasons for expecting that the transition to lower inflation will not be accomplished quickly and easily. One is that the adjustments of most wages and salaries and many prices normally lag changes in the economic environment. Another is that fears and expectations of growing inflation remain very strong and may

continue for a while to dominate wage and price setting behaviour. People need confidence that public policy is capable of staying the anti-inflationary course.

We must recognize that in many respects our domestic markets function less flexibly than one would like. Various market rigidities will tend to make the adjustment to lower inflation a slower and more painful process than it would otherwise be. To the extent that business and labour organizations, marketing associations and similar bodies have and use the power to resist adjustment and to force it on to others the transition will be not only more difficult but also less equitable. This is something that must concern all Canadians.

Problems like those involved in the current slowing of the growth of total spending in the economy are unavoidable if inflation is to be lowered and a solid basis for future economic prosperity is to be built. The more readily we Canadians accept the fact that more moderate increases in total spending imply more moderate increases in money incomes and prices for everyone, the better will be the trend of employment, output, and real income in Canada in the months ahead. The national interest calls for a realistic response by everybody to the changed economic environment. This is what all Canadians must hope for and try to encourage.

Introductory Remarks
by Gerald K. Bouey
Governor of the Bank of Canada
in an appearance before the
Standing Senate Committee
on National Finance
Tuesday, March 23, 1982

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by Gerald K. Bouey
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As you know, my latest Annual Report was published a few days ago. I understand that copies have been made available to the Committee.

In that Report I reviewed Canadian economic and financial developments over the past year. I sought to put them in the perspective of developments in Canada and abroad over a longer period. Much of the Report was devoted to a discussion of the monetary policy pursued by the Bank of Canada in the context of those developments. I tried to describe the nature of the interest rate problem that we have in Canada and to explain why it could not be greatly eased by a change in the policy of the Bank of Canada.

I understand that one aspect of these matters that is of particular interest to this Committee is the one that might be described as the issue of "made-in-Canada interest rates". Accordingly, I shall concentrate the remainder of these opening remarks on that particular topic.

Let me begin with a question. How does anybody recognize made-in-Canada interest rates when he sees them? To what extent is it possible to have a useful definition of made-in-Canada interest rates in an economically interdependent world?

In a free society interest rates are not a wholly arbitrary element in the economic system. They arise from the real productivity of capital and they provide a return to those who save for the future. In the normal course of events they are positive when the value of money is stable, and they are above the general tendency of inflation when there is inflation.

When one looks at current Canadian interest rates in this light there is nothing particularly unusual or exaggerated about them. Certainly interest rates are high by historical standards but so is inflation. When, twenty to thirty years ago, we had very little inflation, interest rates were appreciably higher than the rate of inflation and no one thought this to be odd or unreasonable. No one argued that interest rates above that low rate of inflation were not made in Canada.

The basic point is that, given the current rate of inflation in Canada, interest rates in Canada are in the range that one would expect them to be.

While this is the fundamental situation, interest rates have moved up and down a lot over the past two years or so. Part of the reason

for the upward tendency was that inflation and inflation expectations worsened in Canada over most of that period and in those circumstances there was strong pressure on interest rates to rise. This tendency was particularly noticeable for medium and longer term interest rates as savers became more wary of committing funds at fixed interest rates for extended periods. But much of the volatility of Canadian interest rates around their central tendency has been due to the fact that short-term interest rates in the United States have been particularly volatile with unwelcome but unavoidable effects on Canada.

On several occasions in this period the Bank of Canada has acted to moderate the effect on Canadian short-term rates of sharp movements in corresponding rates in the United States. The most recent occasion was in the period from late in 1981 to date. U.S. short-term interest rates moved up quite strongly but Canadian short-term interest rates stayed relatively steady. The impact on the Canadian dollar of the disappearance for a time of the differential by which Canadian short-term interest rates exceed those in the United States was cushioned by the general belief that the rise in U.S. rates would be temporary.

This is a current instance of the unavoidable fact that shifts in financial conditions in the United States affect the Canadian situation, causing reactions in our interest rates or our exchange rate, or both. The Bank of Canada's response has typically been to smooth and to spread

the impact to the extent feasible -- seeking to avoid abrupt movements in interest rates or the exchange rate that did not seem warranted by Canadian economic conditions. But this does not mean that the central tendency around which interest rates in Canada have fluctuated was inappropriate to Canadian economic conditions. As I have said, the broad trend of our interest rates is what one would expect in the light of our rate of inflation.

We should bear in mind that interest and exchange rate strains do not originate solely in events outside our borders. There is certainly a very large made-in-Canada content in our current high rate of price and cost inflation. And we are capable of generating our own shocks to interest rates and the exchange rate. About the middle of last year the Canadian dollar came under extraordinary downward pressure and short-term interest rates in Canada rose sharply. This was not attributable to any change in U.S. conditions but was caused by developments originating in Canada. The mounting wave of Canadian takeovers of foreign-controlled businesses in Canada had a sharp impact on the exchange market in the month of July. Despite a sharp upward movement of Canadian short-term interest rates the Canadian dollar went down three per cent in the space of three weeks. The rise in interest rates was initially a domestic market reaction to the extraordinary slide in the Canadian dollar, but in the circumstances the Bank of Canada had no responsible alternative but to accept it.

The extreme pressures to which the Canadian dollar has been subjected from time to time in recent years, whether the result of swings in U.S. interest rates or of shocks originating in Canada, have required prompt responses from monetary policy. Our reactions were not motivated by a fixation on maintaining any particular exchange rate. They stemmed rather from a desire to avoid aggravating an already highly inflationary situation through exchange rate instability and loss of confidence in Canada's will to control inflation.

Once lost, confidence in the will and determination of public policy to combat inflation is not easily regained. The effects on financial markets of an erosion of confidence can be rapid and devastating, with very serious consequences for output and employment. Our inflation is at present significantly higher than in the United States. It would be extraordinary to believe that in such a situation Canadian short-term interest rates could be pegged arbitrarily below U.S. rates by means of whatever monetary expansion it would take without generating a sharp decline in the exchange rate. This in turn would lead to still more inflation in Canada, a bigger gap against U.S. inflation, and still further exchange rate pressure. At some point policies would need to be changed to retrieve the situation and what we would finish up with is interest rates higher than they were in the first place.

At the same time, I need hardly say that I very much hope that the United States will be able to conduct its affairs in a way that will

bring about significantly lower and more stable interest rates in that country. Such a development would give us somewhat more room for manoeuvre in conducting our monetary policy. Failure to make good progress in getting the inflation rate down in Canada would, however, severely limit our prospects of achieving a similar decline in Canadian interest rates.

Before I conclude these remarks on made-in-Canada interest rates I want to recognize that some of the concern that I have heard expressed about the influence of U.S. interest rates on Canadian rates is more related to fears about the future than to the current situation. Some forecasts that one sees about the future movements of U.S. interest rates are certainly startling but I believe they are based on overly pessimistic assumptions about how the U.S. situation will develop. I do not think that it is reasonable to expect the kind of dramatic rise in U.S. interest rates that some extreme forecasts show.

Let me end by saying that I am deeply aware of the difficulties, frustration and anger caused by interest rates. I know that there is a great yearning for some easy way out of our current economic problems. But we shall do better if we choose realism over wishful thinking. The goal of the Bank of Canada is to get interest rates down by the only way that can keep them down -- that is, by lowering the rate of inflation in Canada. Monetary policy has responded to developments that pose a threat to that objective, whether the disturbance

originates in Canada or abroad. I regard that as made-in-Canada policy to serve Canada's economic interests.

Introductory remarks
by Gerald K. Bouey
Governor of the Bank of Canada
in an appearance before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs
Thursday, March 25th, 1982

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My latest Annual Report was published less than a week ago. In those circumstances I think I can be brief in these introductory remarks, limiting myself to a summary of some of the main points of that Report.

My main concern has been to deal with the issue of interest rates in Canada. The Bank is very much aware of the pain and frustration that interest rates have caused and are causing. Like others, the Bank wants lower interest rates. Much of what I had to say was devoted to explaining that the only sure route to lower interest rates was through lower inflation. By restraining the rate of monetary expansion, monetary policy is doing the only thing open to it to reduce inflation and reduce interest rates.

I emphasized in the Annual Report that Canada's history as regards inflation and in dealing with it had given rise to strongly entrenched expectations about continuing high inflation. It does not seem to me that Canadians are yet convinced that public policies will be firm

or persistent enough to bring about a substantial reduction in the rate of inflation in Canada. Such embedded expectations make the return to a better economic performance in Canada much more difficult. But it will not be made easier by a return to policies of rapid monetary expansion. In fact we would finish up in a more difficult position, and with higher interest rates, than we have now.

Market conditions are no longer conducive to rapid rises in costs and prices. It is now in the interests of both business and labour that they respond by moderating price and income increases in order to protect employment and output. Businesses that are not able to be competitive will generate neither profits nor jobs. In those sectors of the economy that are not directly exposed to market pressure what is required is that they do not lag the exposed sectors in restraint on increases in incomes. The public sector must recognize its share of responsibility for keeping Canada's costs competitive. So far one sees much more evidence in the United States than in Canada of the responses needed to bring down inflation.

The Bank of Canada announced several years ago that it was going to slow the rate of monetary expansion in a gradual manner. It hoped that this approach would be useful in smoothing the transition to a less inflationary economy. It would give those groups that have the power to influence the prices of the goods or services they supply the chance to adjust their practices accordingly.

Things have not worked out as well in this regard as one would have wished. I have dealt with the reasons for that in my Report. It is clear in retrospect that the resistance offered to inflation by monetary and fiscal policy taken together was not tough enough. If monetary policy had been easier, our situation today would be worse, not better.

I discussed at some length questions related to the implementation of a policy of restraining monetary expansion. I will not review that territory in any detail at this point. However, I want to stress that it has been possible for the Bank of Canada to reconcile the overriding need to control the rate of monetary expansion over time with some freedom to respond to short-term disturbances of either domestic or foreign origin. It has been able to moderate the effects on Canada of sharp swings in U.S. interest rates, and interest rates in Canada have not in fact moved in lock-step with those in the United States. The Bank has also been able to moderate the effect of sharp swings in the flow of capital across our borders. In the summer of 1981 the Bank moderated the effect on the exchange rate of a wave of take-overs by Canadians of businesses in Canada but this required a rise in interest rates at that time.

There is no doubt that monetary policy has an essential role to play in restoring a money that can be trusted -- one that keeps its value over time. But it is also true that the achievement of a better functioning economy depends very heavily upon the policies pursued in

other areas. The more other policies are aimed in the direction of encouraging less rather than more inflation of costs and prices in the Canadian economy, the smoother will the transition to a non-inflationary economy be.

The Bank recognizes that getting inflation down is difficult but the cost of failing to deal with inflation would be very great. Too little attention is paid to the cost of temporizing with inflation. To back off from anti-inflationary policies when the going gets tough would be to enter upon a stop-go cycle of stagnation and inflation. Nobody wants that.

Canada is not alone in this matter. Perhaps we can draw courage from the fact that almost every country in the world is trying to deal with inflation in order to restore a solid basis for economic growth.

NOT FOR PUBLICATION BEFORE 1:00 P.M. EASTERN STANDARD TIME
APRIL 6TH, 1982

MONETARY POLICY AND INTEREST RATES

NOTES FOR REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA,
TO THE MEN'S CANADIAN CLUB OF OTTAWA,
OTTAWA, ONTARIO, APRIL 6TH, 1982

Notes for remarks by
Gerald K. Bouey,
Governor of the Bank of Canada,
to
The Men's Canadian Club of Ottawa,
Ottawa, Ontario, April 6th, 1982

To make a public speech to an audience of Ottawa people is a pretty rare thing for a Governor of the Bank of Canada to do, so rare that I cannot find any record of it ever having happened before. Speeches have been made to groups that come to Ottawa for meetings but that is not the same thing. Why have Ottawa people been singled out for this treatment, or lack of treatment? Could it be that you have already heard more about the activities of the Bank than you want to hear? I hope not.

There was a time when I felt there was little point in making a speech anywhere just after the release of my Annual Report. After all, my main story is in that Report. But I have come to realize that the readership of the Report is rather limited and that the references carried by the media are very brief. So today I want to take advantage of the opportunity to concentrate on the main message in the Report and to comment on a few of the reactions to it that I have noted.

The most important point in the Report is that the Bank of Canada, like others, wants interest rates to be lower and that it is doing what it can to get them down. What the Bank of Canada can do to get interest rates down and to keep them there is to help reduce the rate of inflation by restraining the rate of monetary expansion. That is what we are doing. A decline in the rate of inflation is the only sure route to a lasting decline in interest rates. We know that the process of reducing inflation is painful and costly, but we also know that the cost of failing to deal with inflation would turn out to be much greater.

I might note that this view is the basis for monetary policy in other countries as well. Almost every country in the world is trying to deal with inflation as the best way of establishing a solid foundation for the sustained growth of employment and output. Inflation and unemployment are no longer regarded as separate and unrelated problems.

While I believe that the Bank's position on interest rates is convincingly argued in our Report, I cannot say that everyone has been convinced by it. You would not think so either if you had followed press reports as closely as I have or if you had listened to the comments and questions from members of Parliament that I had to deal with the other day in a session of the Standing Committee of the House of Commons on Finance, Trade and Economic Affairs. There are,

of course, various possible reasons for this. One is that the argument advanced by the Bank is not clearly understood. Another is that it is understood but not agreed with. Still another is that people don't question the argument but just don't like the conclusions.

It is easy to understand the cool reception of the Bank's message if you think of the problem of interest rates from the point of view of those who are suffering most from them. In the Bank we know about this. We hear a great deal about it everyday. To give you just one example, I have received telephone calls that begin with words like these: "This is the day I am going out of business and I want you to know that it's your fault". So we know about bankruptcies, lay-offs and other problems from direct contact with the public as well as from many other sources. Many farmers, small businesses, large businesses, and home mortgage borrowers are facing interest rates that are extraordinarily high by historical standards and they are having a very rough time.

To many of these people their problems appear to have been caused by the policy of the Bank of Canada, a policy they believe the Bank could easily alter substantially any time it chose without causing serious damage to the economy.

Others who find themselves in similar circumstances understand the policy problem but still find the situation difficult

to accept. Recently I had a call from an owner of a small business who, after discussing in a very reasonable manner what would happen if the Bank of Canada tried to push interest rates down sharply and quickly through rapid monetary expansion, told me, "I think you may well be right not to try it but it might let me stay in business for another six months". One must have a great deal of sympathy for people caught like that.

I can well understand why many people desperately want to believe that there is some way for the Bank to bring down interest rates sharply and quickly. That is why we have to explain why that is not practical.

In a free society interest rates have a role to play and their level cannot be fixed arbitrarily. They arise from the real productivity of capital and they provide a return to those who save for the future. In the normal course of events they are positive when the value of money is stable, and they are above the general tendency of inflation when there is inflation. Periods where they have been low relative to the rate of inflation have typically been followed by an acceleration of inflation.

When one looks at current Canadian interest rates in this light there is nothing particularly unusual or exaggerated about them. Certainly they are high by historical standards but so is inflation. When, twenty to thirty years ago, we had very little

inflation, interest rates were appreciably higher than the rate of inflation and no one thought this to be odd or unreasonable.

The basic point is that, given the current rate of inflation in Canada, interest rates in Canada are not far from where one would expect them to be. If inflation was much lower, interest rates could also be much lower.

While this is the fundamental situation, interest rates have moved up and down a lot over the past two years or so. Part of the reason for the upward tendency was that inflation and inflation expectations worsened in Canada over most of that period, and in those circumstances there was strong pressure on interest rates to rise. But much of the volatility of Canadian interest rates around their central tendency has been due to the fact that short-term interest rates in the United States have been particularly volatile, with unwelcome but unavoidable effects on Canada.

On several occasions in this period the Bank of Canada has acted to moderate the effect on Canadian short-term rates of sharp movements in corresponding rates in the United States and has allowed some of the pressure to be taken by the exchange rate. Anyone who believes that interest rates in Canada have simply moved in lock-step with those in the United States has not bothered to look at the facts. Over the past two years short-term interest rates in Canada have been everything from some 4 percentage points below to some 5

percentage points above those in the United States. For a while in February of this year we were able to manage with short-term interest rates that were slightly lower than those in the United States.

Let me say here that I very much hope that the United States will be able to conduct its affairs in a way that will bring about significantly lower and more stable interest rates in that country. Such a development would give us somewhat more room for manoeuvre in conducting our monetary policy.

The fact that short-term interest rates in Canada in the recent past have on occasion been below those in the United States does not mean that such a relationship is available on a continuing basis unless the relative inflation performance of the two countries were to change greatly. Our inflation is at present significantly higher than in the United States. It would be extraordinary to believe that in this situation Canadian short-term interest rates could be pegged arbitrarily well below U.S. rates by means of whatever monetary expansion it would take without generating a sharp decline in the exchange rate. How far would the Canadian dollar fall? If the authorities of a country experiencing marked domestic inflationary pressures, as Canada is, were perceived as following a policy that promoted depreciation, market confidence in the currency would be sharply eroded and the decline would be very great. Experience in such cases indicates that the market would push the rate down so far that the authorities would feel themselves forced to

take strong measures to establish order, and these measures would certainly have to involve a substantial rise in interest rates. In any event, significant depreciation would add substantially to the rate of inflation in Canada and put strong upward pressure on interest rates. In the end interest rates would almost certainly have to be higher than they would otherwise have been.

Those who take the view that if our interest rates were pushed down several percentage points the exchange rate decline would be only moderate reveal among other things a serious lack of understanding of the psychology of exchange markets. They seem innocent of what I recently saw well described as "the relentless way the markets pounce upon currencies perceived as losers".

I have been talking mainly about interest rates and now I want to turn to a more general discussion of what is required to bring inflation down. One part of what is required is an economic climate that will restrain it. This we now have, partly as a result of the onset of an international economic recession. The other, and equally important part, of what is required is a flexible response to that climate by business, labour and the public sector. Our markets for goods and services both at home and abroad are no longer conducive to rapid price and wage increases. It is now in the interests of both business and labour that they respond by moderating price and income increases in order to protect employment and output. Businesses that are not able to be competitive will generate

neither profits nor jobs. In those sectors of the economy that are not directly exposed to market pressure what is required is that they do not lag the exposed sectors in restraint on increases in income. The public sector must recognize its share of responsibility for keeping Canada's costs competitive. So far one sees much more evidence in the United States than in Canada of realistic responses to the facts of the real world as they are today.

One hears much these days about the need of various groups for catch-up. The hard fact of the matter is that Canada is not currently producing enough in real terms to play the catch-up game in either profits or income. To assume that everyone is entitled to at least the increase in the consumer price index, and to more if some group somewhere else in Canada is thought to be better paid, is to assume that the world owes us our notions of a suitable living no matter how we perform in terms of real output. That assumption cannot be taken seriously.

Having indicated that in this matter of bringing down inflation it takes "two to tango" -- anti-inflation policies plus a flexible response to them -- I would like now to pose the question of what a central bank should do if the economy does not respond well to the emergence of a less inflationary climate.

There are many reasons why an economy may not react flexibly to a less-inflationary climate. Maybe people's expectations of future inflation are so deeply ingrained that they simply do not believe that an anti-inflationary financial climate will be permitted to continue. They think that the central bank or the government or both will lack the will to persist in the face of the inevitable strains involved in reducing inflation. Or maybe there are particular business and labour groups in the economy that believe that they can safely ignore general market pressures either because the market for their product or services is protected by one means or another or because they can control the supply of their goods or services sufficiently well to insist on inflationary price and income increases. To the extent that there are reactions like this an anti-inflationary climate will generate cut-backs in production and increases in unemployment rather than better cost and price performance.

What should a central bank do then? What can it do? Its power is essentially one-dimensional. It can increase or reduce the rate of monetary expansion. If the economy does not respond well to market pressures the central bank should not try to paper over the cracks in the economy by printing money. It should not give in to the very real temptation to try to play some residual role that might permit increased activity temporarily but would in the end only lead to higher inflation. If we have practices in our private and public

sectors that tend to promote inflation, let alone inefficiency, they will have to be tackled in a direct manner. They must not be used as an excuse for abandoning reasonable financial discipline.

I raise these difficulties about the response of the economy to anti-inflationary policies partly because they are relevant to a question I am sometimes asked. The question is, how high does the rate of unemployment have to go, how many more bankruptcies have to take place, how many foreclosures have to occur before the Bank will give up its policy of monetary restraint. Since surrendering to inflation is no answer to our problem one might better ask, how long will it take Canadians to respond realistically to the financial discipline our situation requires in order to avoid sacrificing businesses and jobs?

I want to conclude by touching on another question that is sometimes directed to me. It is, what hope can you give us? Is there any light at the end of the tunnel?

The answer is that of course there is hope for an improvement in economic performance although we may still have a difficult period to go through. The international economic recession is still on, and for the same reasons that apply here most other countries do not feel that they have room for major stimulative policies. Nevertheless recessions do generate self-correcting forces and they do come to an end. Many believe that the U.S. recession is

about over and most observers look forward to some recovery in both the United States and Canada during the second half of this year. The question for Canadians is not so much whether there will be an economic recovery in the world as whether Canada will be able to get its house in good enough order to participate fully in that recovery. We are making some progress in getting inflation down but we need to make a good deal more.

It is customary in speeches like this one to end on a high note by pointing to the great future that awaits Canadians as a result of our rich endowment of natural resources. But we seem to be able to get into considerable trouble even with those resources. Perhaps we should look less at our resources and more at ourselves. Are Canadians really incapable of pulling together to build a dynamic, non-inflationary, highly competitive economy. I don't believe that for a minute, and I don't think you do, but we had better get on with it.

THE 1982 PER JACOBSSON LECTURE

MONETARY POLICY -- FINDING A PLACE TO STAND

delivered by
Gerald K. Bouey
Governor of the Bank of Canada

Toronto, Canada
September 5th, 1982

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September 5, 1982

MONETARY POLICY -- FINDING A PLACE TO STAND

Central bankers are always looking for more reliable guides to the conduct of monetary policy than they have had. Part of the reason is that they want to find a better place to stand against the constant pressures that arise from many sources, almost irrespective of economic conditions, for easier money and lower interest rates. Restraint on monetary expansion is never a popular policy. In my experience I have had much more success in convincing people that monetary policy should have been tighter at some point in the past than in convincing them of the need for restraint in the present. The temptation to put off financial discipline is always great. It is not therefore surprising that central bankers have been anxious to find some objective criterion to assist in choosing and explaining the course monetary policy should take.

Most of what I have to say today is concerned more with this search for a better analytic framework within which monetary policy choices are made than with particular policies themselves. But in the

last decade central bankers have learned some hard lessons about where monetary policy should take its stand on the question of how firmly inflation should be resisted and I shall have something to say about that too.

The remarks I have to make on these issues will necessarily mainly reflect Canadian experience, but I do know that much the same questions, much the same challenges, that we have faced in Canada have been confronted elsewhere, and I expect that a great deal of what I have to say will relate quite directly to situations elsewhere.

As you have probably already gathered, for the purpose of this lecture I use the terms 'central banking' and 'monetary policy' virtually interchangeably. I shall be discussing how monetary policy is formulated, not where it is formulated.

In so doing I am of course aware that I am also glossing over the issue of the degree of independence for the central bank within the framework of government and of public policy. This territory was covered with great care and authority by my predecessor and friend, Louis Rasminsky, when he gave the lecture under these same auspices in Rome in 1966. On that occasion he stressed the advantages of arrangements which give the central bank a sufficient measure of independence within government to be held responsible for monetary policy, and also make it clear that the elected representatives of the people have ultimate responsibility and have a suitable mechanism through which to exercise that responsibility.

Before going further, I want to make a few brief remarks about the role monetary policy should be expected to play in a developed industrial economy such as Canada.

In my own institution we operate under an Act of Parliament which in its preamble contains the following brief description of the role of monetary policy:

> Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion.

This description, written in the mid-1930s, seems to me to stand up very well today. It recognizes that the prime focus of monetary policy should be at the macro-economic level rather than with the operation of particular segments of the economy. It also recognizes, by the important qualifying phrase "so far as may be possible within the scope of monetary action", that there are limits to the extent that some of the economic objectives mentioned can be pursued effectively by monetary means.

This point deserves further emphasis. In considering monetary policy it is important to have the clearest possible idea of what can, and what cannot, be properly expected from monetary policy in the first place.

In a developed industrial society like ours a characteristic feature is the heavy reliance that is put upon decentralized decision-making in economic matters. That decentralization is made possible by a relatively large and highly diversified private sector and the use of market mechanisms. In such societies public economic management relies mainly on influencing the framework within which markets operate, and only to a limited extent, or exceptionally, on direct controls, rationing, or administrative allocation in general. The role of monetary policy in such a society is to seek such rate of monetary expansion as will encourage the market economy to work well.

It is surely now beyond dispute that one of the prime requirements for good economic performance over time in a market economy is a money that can be trusted. Monetary policy must therefore give high priority to the preservation of the value of money. Its freedom to respond to particular situations must therefore be seen as constrained by this longer term objective.

It follows from the proper role of monetary policy that there are many economic problems that are outside its scope. There are many economic problems that cannot be effectively resolved merely by printing money, and it is a mistake to try. If a market-oriented economy does not work well with a rate of monetary expansion that is consistent with the preservation of, or a move towards, stability in the value of money, the sensible response is to track down the true sources of the problems and deal with them.

One feature of an economy that is outside the scope of monetary policy, and which I want particularly to emphasize in this lecture, is the degree of flexibility with which the economy responds to the forces operating in it, including the influence of monetary policy. I plan to return later to that question in the context of the special problem of bringing down the rate of inflation. Here it is sufficient to note that given the limits to its scope monetary policy cannot by itself ensure good over-all economic performance. As has often been stated, a good monetary policy is a necessary but not a sufficient condition.

How in these circumstances does a central bank go about deciding how to pursue a 'good' monetary policy -- one that will exert the appropriate influence on total spending in the economy? I will centre the rest of my remarks on the guides which have been used for tackling this problem in Canada. This amounts to a commentary on how thinking and practices have developed over the years that I have been involved in this business, what we seem to have learned, and what difficulties we have come up against.

Whatever else has changed over the years, the basic view of the Bank of Canada of how monetary policy works -- the process by which it has its ultimate economic effects -- has not changed. That view is that interest rates constitute the cutting edge of monetary policy. The main policy problem has thus always been seen, and is still seen, as how to come to judgements about the direction and extent of the influence that the central bank should exert on the path of short-term interest

rates. Those judgements are very difficult because of the complex process through which interest rates affect total spending in the economy.

In looking at the Canadian experience with monetary policy three separate periods can be identified. The first is the period of low and stable interest rates that followed the establishment of the Bank of Canada in 1935. The beginning of the 1950s marks the inception of the next period, one in which monetary policy played a more active role. Finally, the adoption of monetary targets in 1975 is the feature which distinguishes the third period.

In the difficult years of the Depression it was clear that the influence of the central bank should be directed toward keeping interest rates low; the economy was in need of expansionary stimulus and there was no inflation risk. In the Second World War, war finance was also based on low interest rates although this policy was accompanied by a comprehensive set of direct controls. While there was a sharp upward adjustment of prices in the immediate post-war period, widespread concern that the war years would turn out to have been just an interlude in a continuing state of economic depression played a major role in keeping serious inflationary expectations from developing and interest rates remained low. Throughout the first fifteen years of the history of the Bank of Canada, 1935-1950, the Bank Rate, the minimum rate at which the Bank makes advances, was changed only once -- it was lowered from 2 1/2 per cent to 1 1/2 per cent in 1944. The rate of monetary expansion was whatever was consistent with the maintenance of low interest rates.

For this reason measures of the money supply, although published, received little attention.

Another reason for the low interest rate policy in the early post-war period was that considerably more emphasis tended to be placed on fiscal policy as an economic stabilizer than on monetary policy. There was, as you may recall, little confidence at that time in the effectiveness of interest rate movements in influencing the course of total spending in the short run, although this view was based on evidence that now seems to have involved incredibly small changes in interest rates. To the extent that there were pressures on the exchange rate, they were managed by other means and did not intrude on monetary policy.

In the 1950s the orientation of monetary policy changed to one of playing a more active role in the stabilization of the business cycle. Initially this change stemmed from a tendency for the economy to overheat at the time of the Korean War. As time went on it was also a response to increasingly ambitious views both in Canada and abroad about the standards of over-all economic performance that ought to be attainable by good economic policy.

With this more active role for monetary policy it was not sufficient to think of policy targets solely in terms of interest rates partly because many interest rates were sticky or even rigid as a result of institutional or legislative constraints. There was moreover a considerable reluctance among the authorities to see large movements in

interest rates and monetary actions were supplemented on a number of occasions by moral suasion which also involved non-price rationing of credit. Policy was therefore framed for much of the period from 1950 to 1975 in a broader form, which we called 'credit conditions', that emphasized the availability of credit as well as its cost.

In Canada banks were the major lenders and influencing credit conditions was to a considerable extent a matter of affecting the ability and willingness of the banks to make loans. Liability management by banks was not yet in style and the amount of liquid assets held by the banking system was regarded as a major factor affecting the availability of bank credit. In its monetary management the Bank of Canada tended therefore to attach considerable importance to the extent that the banks acquired or disposed of liquid assets.

Despite the optimism in many quarters about the achievable standards of economic management, the day-to-day business of monetary decision-making was by no means a precise exercise. Indeed my recollection is that at one time we referred to the policy process as being one of trial and error but since no one liked the word 'error' to be included in a description of central bank policy we quickly adopted the more elegant term 'successive approximation' when it began to be used south of our border.

This process was described in a submission by the Bank of Canada to a Royal Commission on Banking and Finance in 1962:

> There is, of course, no formula by which the central bank can determine what are the most appropriate credit conditions or what level of cash reserves would bring them about. It must operate to a considerable extent by the method of successive approximation, constantly adjusting its operations in the light of all the evidence it can get, as it becomes available, about changing economic and financial conditions.

At this time the Bank expressed concern that over-reliance on monetary policy be avoided because of its undesirable side effects. These side effects included the uneven impact of both non-price rationing of credit and high interest rates on various classes of borrowers and the effect of volatile interest rates on financial markets, on the country's external financial position and on the maintenance of exchange rate stability. This view of the role of monetary policy implied that a large part of the stabilization burden should continue to be carried by other economic policies, especially fiscal policy. A similar view was expressed in 1964 by the Royal Commission on Banking and Finance in the following terms:

> Monetary policy is just not powerful enough to do the job by itself over any reasonable range of credit conditions, even if there were no international inhibitions about using it fully.

Despite the focus on credit conditions the money supply was not totally ignored. In the 1950s and the 1960s there were indeed periods of concern about the rapid growth of broadly-defined measures of the money supply but there were no well-established relationships which could be used to interpret these monetary aggregates.

By the late 1960s the elimination of the interest rate restrictions in banking legislation as well as elsewhere had opened the way for much greater flexibility in interest rates in Canada, a flexibility which turned out to be crucial given what later happened to international interest rates. Non-price rationing of credit, or availability, became very much less important and credit conditions really came to mean interest rates.

This general approach to monetary policy worked reasonably well for much of the period from 1950 to 1970. Despite a tendency to generate stronger and stronger levels of aggregate demand at the peak of each cycle, economic policy did not run into serious trouble so long as the public did not expect more than temporary bouts of inflation. Undoubtedly the discipline of fixed exchange rates helped to hold things together for a while. But the increasing pressures on prices from expansionist policies gradually undermined belief in the commitment to price stability by the authorities and led to expectations that inflation was more likely.

During the recession at the beginning of the 1970s, monetary policy was directed toward bringing about a relatively low level of interest rates. Fiscal policy was also eased. This had been the usual pattern but on this occasion virtually all industrial countries were in the same phase of the cycle and their policies interacted to produce a powerful, synchronized economic expansion. One of the reasons for the willingness of monetary authorities to pursue easy monetary policies at that time was related to the fact that the Bretton Woods fixed exchange

rate system was in the process of breaking down. No country wanted a rise in interest rates that would cause its currency to appreciate sharply because of a fear that a loss of international competitiveness in an already disrupted international market could put an unnecessary obstacle in the path of an economic recovery. The old problem of competitive exchange rate depreciation was back temporarily, though in a different guise. The difference was that this time it was competition to avoid exchange rate appreciation. This immediate concern about exchange rates clearly received priority over the associated risk of future inflation. I am inclined to believe that this development was a major reason why the eruption of inflation was so much greater on this occasion than in previous peacetime recoveries. It is well to remember that all this occurred before the sharp rise in international oil prices in 1973 added a further inflationary shock to the world economy.

It is no exaggeration to say that the world economy is still trying to recover from the inflation unleashed in that period.

The strength of the sudden burst of economic expansion in the early 1970s was not foreseen. In Canada, fiscal policy remained easy for some time, and monetary policy did not react quickly or vigorously to the surge in activity. When the Bank Rate was raised in April 1973 I found myself asking the rhetorical question in a public address: "Why would the Bank of Canada raise the Bank Rate when the latest unemployment figure was still as high as 5.9 per cent?". But it was already late in Canada as elsewhere. Successive increases in the Bank Rate followed, and although nominal interest rates went to historically

high levels it later became clear that they had not risen rapidly enough. The attempt to achieve appropriate interest rate levels in this period foundered mainly because of the inability to recognize what nominal interest rates were needed when actual inflation and expectations of future inflation were rising so quickly.

It was natural that central banks would look back over the period in which inflation exploded in an attempt to see what would have improved the performance of monetary policy. In Canada what this revealed was that the expansion of the money supply, particularly the narrow definition composed of currency and demand deposits, had accelerated well ahead of the rate of inflation. It appeared that a policy more closely oriented to stabilizing monetary growth would have reduced the cumulative increase in inflation that occurred. While this persuaded us that we ought to pay closer attention to what was happening to the money supply, work went on over quite a long period at the Bank of Canada before we felt that we had a reasonable basis for expressing our policy in terms of the movement of a particular monetary aggregate, and a feasible way of linking our actions in financial markets to movements in that monetary aggregate.

The decision in 1975 by the Bank of Canada to adopt a money supply target was based on the evidence that a narrowly-defined monetary aggregate (M1) was related in a reasonably stable fashion to movements in total spending in the economy and to short-term interest rates. Short-term interest rates continued to be viewed as the channel

for the transmission of policy; the role of the monetary aggregate was to assist in making judgements about the appropriate level of interest rates.

This modified approach was also a reaction to the limited help, despite increasingly sophisticated econometric models, that economic forecasting and policy simulation techniques had been able to provide to policy-makers in coping with the outbreak of inflation. The attraction of using the trend of a monetary aggregate as a guide for policy was that it limited the need for judgements about the likely evolution of economic developments in the near-term future and shifted the focus of policy to a longer time period. It gave more prominence to the need to restrain the rate of monetary expansion over time if the previous tendency of policy to have an inflation bias was to be avoided in the future.

The Bank of Canada, like many other central banks, began at this time to announce publicly its targets for monetary growth. We were aware of the important role of expectations in economic processes and were hopeful that the announcement of targets for policy would influence expectations and thereby speed the responses to policy. Moreover, the Bank would have a more solid place to stand in defending the actions that were undoubtedly going to be necessary to fight inflation.

The use of monetary targetting has become widespread in industrial countries and has unquestionably assisted in achieving a wide measure of public support for the need for monetary restraint in order to bring about a return to price stability. There is no doubt in my mind that without the adoption of guidelines for money growth by central

banks the unprecedented interest rates that have been needed to moderate inflation would have been delayed, if they would have been forthcoming at all.

As I noted earlier, the danger of coming to rely excessively on monetary policy for financial restraint had been a preoccupation for some time because of the uneven impact of unusually high interest rates. The concern was reinforced in this latter period. While interest rates were bound to rise appreciably in view of the upsurge of inflation, all central bankers would have preferred mixes of fiscal and monetary policies at home and abroad that would have obviated the need for such high interest rates.

Notwithstanding the contribution of monetary targetting in getting monetary policy on to a better track, practical problems have emerged in Canada, and I expect in other countries as well, which have reduced the usefulness of these targets as policy guides. I want now to describe the problems that we have encountered.

Perhaps the most troublesome problem in Canada is that the relationship between our target monetary aggregate -- M1 -- and the levels of spending and interest rates has not turned out to be as stable as it appeared in the mid-1970s. Inflation and high interest rates have led to a rapid pace of financial innovation, spurred on by advances in computer technology. The resulting shifts in the quantity and composition of money balances that the Canadian public chooses to hold have been substantial. These shifts cannot be ascribed to financial

deregulation because the financial system in Canada has for some time been free of the kind of regulatory impediments that would have been relevant.

These shifts in money demand have been difficult to handle. There have been periods when the movement of M1 relative to its target was known to be misleading but it was not possible to make a reliable estimate of the size of the shift except after a considerable lapse of time. The interpretation of M1 has also been complicated temporarily by problems in measuring this aggregate arising from reporting difficulties encountered by Canadian banks following revisions to the Bank Act. When confronted with a substantial and unexpected movement in money, the Bank of Canada has been obliged to look for supporting evidence that the movement reflected fundamental economic developments and not just changes in financial arrangements.

The evolution towards electronic means of making payments is likely to lead to further important adjustments in the form of money balances that the public chooses to hold. It remains to be seen what sort of adjustments to monetary targetting will be required in the face of such innovations.

So far at least, our examination of monetary aggregates that are more broadly defined does not indicate that they would provide attractive alternatives to M1.

Another very practical issue in monetary targetting has been how to cope with exchange rate disturbances. In our own case there have been a number of occasions in recent years, and especially in the past two years, when the Bank of Canada has felt obliged to react quite strongly to exchange rate movements. These instances have been connected mainly with downward movements in the Canadian dollar related to unusually high U.S. interest rates, although sometimes they have reflected developments of domestic origin.

In an open economy such as Canada's, currency depreciation is bound to have both an immediate effect on prices and a lagged secondary effect as individuals and businesses try to protect their incomes in the inflationary environment. The higher rate of inflation will in due course be reflected in a rise in the quantity of money demanded in the economy, and thus will signal the need for more monetary restraint, but by that time the damage in terms of increased inflation and strengthened expectations of future inflation will already have been done.

Other central banks have encountered similar problems. Unusually high external interest rates lead either to domestic interest rates that are higher than necessary to meet monetary targets or to a decline in the exchange value of the currency with its consequent inflationary effects. It is not possible for domestic monetary policy to avoid both of these problems at the same time. The reverse of this problem can occur if external interest rates are unusually low.

I should perhaps note in passing that for some countries, especially smaller ones, the option of operating monetary policy to stabilize the exchange rate, whether a bilateral or trade-weighted exchange rate, rather than the growth of the money supply, can be quite attractive. Such a policy guide in effect transfers much of the responsibility for the basic direction of monetary policy to a country or group of countries that are of great economic importance to the country in question and whose actions will in any case have to be accommodated by smaller countries somehow. Such a policy, if adhered to, ensures pretty much the same inflation performance over time as the country or countries with which the exchange-rate link has been established. In principle this could be better or worse than would have been achieved under some kind of purely domestic regime; in practice, exchange rate targetting makes more sense the less scope there is to realize good monetary management by focussing mainly on internal financial developments.

Given the important role of expectations in perpetuating inflation, we in the Bank of Canada have found ourselves taking a view of policy that is more forward-looking than one based solely on monetary targets on the grounds that it is wise to respond immediately to any potentially inflationary shocks rather than to wait until such shocks are reflected in higher inflation and higher money growth. This is of course a bit different from the rather pessimistic view about the state of economic knowledge which influenced much thinking immediately after the outbreak of severe inflation in the mid-1970s and was one of the bases for the advocacy at the time of a monetary rule. We do know more about

economic processes than is typically assumed by advocates of a strict adherence to such a rule. This is not to say we can forecast over-all economic developments with any degree of certainty but we do know something about the implications of various kinds of shocks. Exchange rate depreciation has been the most important of these. We have also come to the view that permitting short-term interest rate levels that are low relative to the rate of inflation is likely to lead to disproportionate incentives for increased borrowing, thereby fuelling speculative activities and contributing to inflationary pressures. On the other side, rates of interest which exceed the inflation rate by an unusually wide margin may, if they persist, exert more anti-inflationary pressure on the economy than it is capable of absorbing without major disruption. These then are considerations that we also take into account in responding to current developments.

For these various reasons the Bank of Canada's use of a monetary target as a guide to policy has been considerably qualified and we have relied a good deal on other information and analysis.

In this discussion of the evolution of our monetary policy framework, my references to the economic context have been incidental to the main theme. Now, however, I want to focus more directly on the issues raised for monetary policy by the actual situation facing us and other central banks.

At present the immediate policy problem for most central banks is not to devise ways of running monetary policy that guard against the

emergence of inflationary pressures. It is rather to ensure that monetary policy exerts sustained and appropriate downward pressure on an existing high rate of inflation and thus restores confidence in the value of money. This problem raises issues that stretch beyond questions of monetary policy technique. Looking solely at the behaviour of financial variables, whether monetary aggregates, interest rates or whatever, will not provide a sufficient basis for judging the question of how strongly to press financial restraint. That judgement will involve a consideration of how the economy responds.

Most countries have for some time had great difficulty in generating anything at all close to a decent economic performance overall. One manifestation of these difficulties is the distressingly high levels of unemployment and large numbers of business failures that are being experienced in Canada and many other countries. It is generally recognized that much of what we find unsatisfactory about the ways our economies have been performing is the product of deep-seated, complex problems. One such problem is the way productivity has lagged throughout the industrial world for a decade or more, frustrating expectations of rapidly rising real incomes. Another, certainly for Canada, is the disconcerting manner in which rates of measured unemployment that might reasonably be thought to be consistent with avoiding inflation have evidently increased from where they were a number of years ago. It is also true, however, that much of the clearly inadequate economic performance recently is related to the stresses involved in the adjustment of the economy to a less inflationary environment.

Reducing inflation has proven to be a difficult and wrenching process. One basic reason is that expectations about future inflation are deeply ingrained. One of the facts of life that policy-makers have had to contend with world-wide has been a general skepticism among the public about the willingness or ability of the authorities to take the steps required to reduce inflation and to persevere in the face of the inevitable strains involved. The history for many countries had been one of taking chances in economic policy on the side of inflation whenever there appeared to be an option. Even as inflation mounted and was increasingly recognized to be a truly serious problem, skepticism over the likelihood of its ever coming under control was reinforced by increasingly frequent suggestions that it should be 'lived with' at whatever rate it had then reached. Thus nowadays it does not take much evidence of weakness of purpose, or evidence even of cross purposes, on the part of economic policy authorities to set off anticipatory expectations in asset markets of all kinds. These episodes serve as a salutary reminder that the days when it was thought that a quick demand boost could be given to the economy without worrying about inflation are over.

Expectations of future inflation both encourage, and are encouraged by, uncompetitive wage and price-setting behaviour. Such behaviour can be an obstacle to good economic performance at any time, but it is likely to be even harder to contend with when the economy is being pressed towards achieving lower rates of inflation. There may be particular business and labour groups in the economy that believe they can safely ignore general market pressures either because the market for their products or services is protected by one means or another or

because they can control the supply of their goods or services sufficiently well to insist on inflationary price and income increases. In some cases the saving of jobs appears to be given a lower priority than the maintenance of high income settlements. To the extent that there are reactions like this an anti-inflationary climate will generate cutbacks in production, business failures, and increases in unemployment rather than better cost and price performance.

If the economy does not respond well to market pressures, this does not mean that the central bank should abandon its efforts. The persistence and credibility of anti-inflationary policies is necessary to change ingrained expectations, and this credibility can only be achieved by actual evidence of success. Furthermore, there would be no point in trying to compensate for deficiencies in the economic structure by printing money at a faster rate. The solution lies elsewhere. A country that depends heavily on market-oriented policies such as fiscal and monetary policy cannot afford to be indifferent as to how well its markets for goods and services work.

In current circumstances the room for manoeuvre for monetary policy is clearly limited. The basic requirement is that it must unmistakably be pointed in the direction of restraint. But there can be some scope for judging how much restraint is required in the light of the developing circumstances of the economy. The process by which the economy adjusts to declining rates of inflation is hardly a smooth one and it is bound to take time. In this area, as in many others, the important aim should be to establish and keep momentum. If considerable

progress has been made in reducing inflation, and if the market situation has become weak in the process, a lesser degree of restraint should be sufficient to continue to make progress against inflation.

In light of these comments you will not be surprised with my conclusions in regard to finding a place to stand. There is no question that targets for monetary growth have provided us with help in warding off pressure for more rapid monetary expansion and protection against cumulative error. Even though we have not found that they can substitute for the wide range of judgements that have to be made, they added a useful measure of discipline to the process of determining the course of monetary policy. But monetary targets have not, at least in Canada, provided the clear place to stand for which some had hoped.

I recognize that the experience of different countries has varied and some central bankers may feel that monetary targetting has brought them closer to a solid place to stand than I believe it has in Canada.

So far as the objectives of monetary policy are concerned I believe we have learned from the experience of the last decade where we must stand. We must be determined not to temporize with inflation. Regardless of what operating guides have been used there has been too great a tendency for too long to take risks on the side of inflation. Since it has proven so hard to halt the process we now know for certain that we should not give inflation a place to start. Economic performance

over time will be better if monetary policy never loses sight of the goal of maintaining the value of money.

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ALLOCUTION PRONONCÉE

PAR GERALD K. BOUEY

GOUVERNEUR DE LA BANQUE DU CANADA

À LA 53e ASSEMBLÉE ANNUELLE

DE LA CHAMBRE DE COMMERCE DU CANADA

À OTTAWA (ONTARIO)

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par Gerald K. Bouey
Gouverneur de la Banque du Canada
à la 53e Assemblée annuelle
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En guise d'introduction à la séance d'aujourd'hui, je vais essayer, comme vous me l'avez demandé, de brosser un tableau très général qui servira de base aux discussions sur la politique monétaire. Mon exposé comportera deux volets. Dans le premier, je ferai quelques commentaires d'ordre général sur la nature et le rôle de la politique monétaire dans une société industrielle à économie de marché comme celle que nous avons au Canada, sur la façon dont les taux d'intérêt et le taux de change sont déterminés dans cette société et sur les relations existant entre ces taux et le taux d'inflation. Dans le second volet, je ferai quelques remarques sur la situation économique qui existe actuellement au Canada, tout en m'efforçant de la replacer dans son contexte.

Permettez-moi de commencer par souligner une chose que vous connaissez tous, à savoir le caractère très diffus du processus de prise de décisions dans l'économie canadienne. Il y a une masse extraordinaire de décisions relatives à la production - quoi produire, comment le produire, où, quand, pour qui produire, à quel prix vendre et que faire des revenus créés dans le processus de production et de distribution -, et la

plupart de ces décisions sont prises par des individus ou des groupes privés liés les uns aux autres par l'intermédiaire des marchés. Dans une société comme la nôtre, les pouvoirs publics s'en remettent principalement, dans la gestion de l'économie, à la pratique consistant à influencer le cadre dans lequel fonctionnent les marchés. Ils n'ont recours que dans une mesure assez limitée, ou que dans des cas exceptionnels, à l'intervention directe. Vous ne serez donc pas étonnés de m'entendre dire que les pouvoirs conférés à la Banque du Canada par le Parlement ont été conçus à l'intention d'une banque centrale oeuvrant dans une économie de marché de type décentralisé.

Une économie de marché développée a besoin d'un grand nombre de services financiers. Dans notre pays, ces services aussi sont en grande partie le fait de l'initiative privée. Pour que les mécanismes en place fonctionnent adéquatement sur longue période, il doit exister quelque part dans le système un moyen de gérer la masse monétaire. C'est là le rôle de la politique monétaire. Cette politique est, par sa nature, une responsabilité des pouvoirs publics et elle est généralement mise en oeuvre par les banques centrales.

Au Canada, la politique monétaire relève directement de la Banque du Canada. La Banque a donc pour principal objectif d'amener la masse monétaire à s'accroître au rythme qui réponde le mieux aux besoins de l'économie canadienne.

Je ne décrirai pas en détail les moyens techniques auxquels la Banque peut recourir pour réaliser cet objectif, mais je puis vous assurer qu'ils conviennent à la tâche. Les problèmes relatifs à l'arsenal des contrôles dont dispose la politique monétaire revêtent tout au plus une importance secondaire. Le problème fondamental qui se pose à la Banque du Canada, et d'ailleurs à toute banque centrale, est de comprendre l'ensemble complexe du processus économique et financier suffisamment bien pour être en mesure de tracer le profil d'expansion monétaire qui servira le mieux les intérêts économiques de la nation.

Je ne crois pas qu'il puisse exister de graves divergences d'opinions sur la question de l'objectif fondamental qu'on devrait viser en matière d'expansion monétaire. L'expansion monétaire dans un pays donné devrait se poursuivre à un rythme qui garantisse une stabilité raisonnable de la valeur de la monnaie, ou, en d'autres termes, une stabilité raisonnable des prix. Cette généralisation aurait peut-être été considérée comme discutable il y a une ou deux décennies, mais peu de gens en contesteraient la justesse aujourd'hui. Les dommages causés par l'inflation sont trop graves et trop manifestes pour qu'on n'en tienne pas compte. Les économies de marché ne fonctionnent pas, et ne peuvent pas fonctionner, de façon adéquate sans une monnaie qui inspire confiance. La détermination de soutenir la valeur de la monnaie doit être à la base de la mise en oeuvre de la politique monétaire.

Je me rends parfaitement compte que le retour à une meilleure évolution des prix s'avère très ardu après la période d'inflation aiguë que nous avons connue. Bien entendu, le retour immédiat à la stabilité des prix n'est pas un objectif raisonnable dans un pays où l'inflation et les anticipations d'inflation sont enracinées aussi profondément qu'elles le sont au Canada. Ces conditions soulèvent un ensemble particulier de problèmes de transition dont je traiterai dans la seconde partie de l'exposé.

Toutefois, avant d'aborder ces problèmes, j'aimerais dire quelques mots de la façon dont les taux d'intérêt et le taux de change sont déterminés dans notre pays. Il n'est pas rare d'entendre les gens parler comme s'ils croyaient que la Banque du Canada fixait le niveau des taux d'intérêt et du taux de change et qu'elle pouvait faire varier ces taux comme elle l'entendait. C'est là une grave erreur.

Tant les taux d'intérêt que le taux de change sont déterminés essentiellement par l'interaction des forces du marché. Dans une conjoncture économique quelconque, compte tenu des politiques économiques des pouvoirs publics, des pratiques du secteur privé et du rythme d'expansion monétaire, les emprunteurs et les prêteurs, les producteurs et les consommateurs de même que les résidents et les étrangers prennent des décisions qui influencent les marchés financiers et déterminent indirectement le profil des taux d'intérêt et du taux de change. Ces taux varient sous

l'effet des modifications importantes de la conjoncture économique, même si le taux d'expansion monétaire ne change pas. Ils varient également si le taux d'expansion monétaire change. Ainsi, la Banque du Canada peut influencer ces taux en modifiant le taux d'expansion monétaire. Mais, dans la pratique, la mesure dans laquelle la Banque peut exercer cette influence est sujette à d'importantes limites.

J'aimerais développer un peu la question des taux d'intérêt. Qu'arriverait-il dans la conjoncture actuelle si, en supposant toutes choses égales par ailleurs, la Banque du Canada devait chercher à faire baisser substantiellement les taux d'intérêt au Canada en accroissant considérablement le rythme d'expansion monétaire? Les taux d'intérêt commenceraient probablement par baisser, mais la baisse, sauf peut-être dans le cas des taux à terme extrêmement court, ne durerait que le temps qu'il faudrait aux marchés financiers pour comprendre ce que fait la banque centrale. Une fois que les marchés financiers auraient compris ce qui se passe, ils agiraient en anticipant une forte accélération de l'expansion monétaire qui entraînerait à brève échéance une forte accélération de l'inflation. Au Canada, l'accélération de l'inflation serait facilitée et même aggravée par une baisse du cours du dollar canadien, elle-même extrêmement difficile à contrôler. Avant longtemps, personne ne voudrait prêter de l'argent à des taux d'intérêt moins élevés, ni même aux mêmes taux, et le loyer de l'argent augmenterait. En fin de compte, l'initiative de la banque centrale aurait des effets néfastes.

Les réactions des marchés dont je parle ne sont pas d'ordre théorique, mais pratique. Elles se produisent tout le temps. Les niveaux auxquels s'établissent les taux d'intérêt et le taux de change à un moment donné sont toujours réévalués à la lumière de ce qui, dans l'esprit des participants au marché, va se produire dans l'économie canadienne dans un avenir prévisible. Si l'on veut que les taux d'intérêt ou le taux de change évoluent de façon très différente, on doit convaincre ceux qui s'engagent sur ces marchés que les événements se dérouleront d'une façon différente de celle qu'ils envisagent.

Ce sont là mes commentaires d'ordre général. Passons maintenant à la situation économique qui existe actuellement au Canada.

Il s'agit là d'une situation peu reluisante. La production nationale baisse depuis un an et elle est maintenant de quelque 6 % moins élevée qu'elle n'était il y a un an. Le taux de chômage a augmenté considérablement et dépasse aujourd'hui les 12 %; il n'a jamais été aussi élevé depuis les années 30. Et quoique le taux d'inflation ait baissé, et continue de baisser, par rapport aux sommets qu'il avait atteints auparavant, il est encore de l'ordre de 10 %. Il y a donc tout lieu de s'alarmer.

Au cours de l'année qui vient de s'écouler, les taux d'intérêt au Canada ont atteint des niveaux extrêmement élevés. Le taux de base des banques canadiennes a atteint un sommet

de 22 3/4 % il y a un an, après que le taux de change eut enregistré une baisse substantielle. Les taux d'intérêt canadiens sont aujourd'hui bien au-dessous de ces sommets. Le taux de base est maintenant de 15 1/2 %, ayant diminué d'environ 3 points de pourcentage au cours des dernières semaines. La croissance de la masse monétaire et des indicateurs du crédit en général a eu tendance à se ralentir, mais il est plus difficile maintenant d'interpréter l'évolution à court terme de la masse monétaire à cause des déplacements et des réaménagements financiers dont j'ai déjà parlé de façon assez détaillée à d'autres occasions.

La Banque du Canada, comme bien d'autres, aimerait voir se poursuivre la baisse des taux d'intérêt, mais l'ampleur des baisses possibles dépend principalement de deux facteurs : le taux d'inflation au pays et les taux d'intérêt à l'étranger. Ces derniers temps, une baisse des taux d'intérêt américains, qui s'est maintenant en partie inversée, a contribué à rendre possible une diminution des taux canadiens. Les taux d'intérêt canadiens peuvent peut-être encore baisser par rapport au taux d'inflation si la situation à l'étranger s'y prête, mais la marge de manoeuvre n'est pas grande. Aucune baisse importante et durable des taux d'intérêt n'est possible au Canada sans une baisse substantielle du taux d'inflation.

Ce point mérite qu'on s'y attarde. La Banque du Canada doit tenir compte, dans la mise en oeuvre de sa politique monétaire, des répercussions inévitables que les variations des taux d'intérêt américains ont au Canada. Au cours des trois dernières années, la Banque du Canada est intervenue à plusieurs reprises pour atténuer les effets que les fortes variations des taux d'intérêt à court terme américains avaient sur les taux canadiens correspondants, tout en permettant à ces pressions de se répercuter en partie sur le taux de change. Ainsi, les écarts entre les taux pratiqués au Canada et aux États-Unis ont en fait varié dans des proportions considérables. Quant à la tendance fondamentale des taux d'intérêt au Canada, elle est déterminée surtout par l'évolution du taux d'inflation, et ce taux est à l'heure actuelle beaucoup plus élevé au Canada qu'aux États-Unis.

Si l'on observe la situation économique difficile que connaît actuellement le Canada, on constate que les entreprises sont prises comme dans un étau, entre, d'une part, une faible demande pour leurs produits et, d'autre part, des coûts de production de plus en plus élevés. Cela est vrai de presque toutes les catégories d'entreprises - les grandes et les petites - y compris les entreprises agricoles. Voilà la cause de la montée du chômage et de l'augmentation du nombre des faillites.

Bien que les politiques monétaire et budgétaire appliquées au Canada au cours des dernières années aient visé à créer une

conjoncture économique anti-inflationniste, la récession économique mondiale est maintenant une des principales causes de la faiblesse de la demande de produits canadiens. A cause de la situation de trésorerie très serrée des gouvernements fédéral et provinciaux au Canada et de la mauvaise conjoncture que connaissent les marchés financiers, il est extrêmement difficile d'accroître les dépenses publiques pour renforcer la demande au pays. J'ai déjà parlé des contraintes qui empêchent de stimuler la demande au Canada par une baisse des taux d'intérêt.

Ce qui peut être fait pour desserrer l'étau dans lequel sont prises les entreprises au Canada et pour atténuer les retombées que cela a sur l'emploi, c'est de ralentir le rythme d'accroissement des coûts dans l'économie. Les marges bénéficiaires ont déjà réagi à la faiblesse des marchés en s'amenuisant considérablement. Au deuxième trimestre de cette année, elles avaient diminué de 44 % par rapport au premier trimestre de 1981. Ce qui aiderait le plus maintenant, c'est un ralentissement du rythme d'accroissement des coûts en main-d'oeuvre. Cela permettrait alors au taux d'inflation et aux taux d'intérêt de baisser.

Pour que notre économie fonctionne adéquatement, le taux d'accroissement des revenus doit réagir au ralentissement de la dépense globale. Celle-ci accuse actuellement au Canada un ralentissement marqué, mais la réaction des demandes au chapitre

des revenus n'a pas été jusqu'à présent assez forte. Cela ne veut pas dire que le taux élevé d'inflation que connaît le Canada soit imputable à un groupe quelconque de la société. Je veux que cela soit très clair. Les augmentations des taux moyens de rémunération n'ont pas précédé, ces dernières années, les augmentations du taux d'inflation. Mais comme les coûts en main-d'oeuvre représentent environ les deux tiers de l'ensemble des coûts dans l'économie, l'inflation ne peut pas se ralentir de façon marquée ni se maintenir à un rythme lent si les taux d'augmentation des salaires et traitements ne diminuent pas dans les secteurs public et privé. Cela ne signifie pas que l'évolution des revenus réels doive refléter le ralentissement de la croissance des revenus nominaux. Les augmentations des revenus nominaux et le taux d'inflation auraient tendance à diminuer en même temps. A la longue, l'ensemble des biens et services produits au Canada sera plus considérable si le taux d'inflation est beaucoup plus bas, et le taux tendanciel de croissance des revenus réels sera plus élevé.

Il serait peut-être utile d'illustrer par quelques chiffres l'orientation que doit prendre l'augmentation des revenus. Si, par exemple, le taux d'inflation au Canada doit baisser pour s'établir au niveau du taux américain, qui pourrait fort bien n'être que de 5 % l'an prochain, les taux d'augmentation stipulés dans les accords salariaux devront passer d'une façon ou d'une autre du niveau d'environ 12 % (clause d'indemnité de vie chère exclue), où ils se situent depuis quelque temps, à quelque 5 ou 6 % selon la tendance de la productivité. Il s'agit

là purement et simplement d'une approche arithmétique. Tant que les choses n'iront pas dans ce sens, nous continuerons de faire face à des problèmes d'inflation, de taux d'intérêt, de production, d'emploi et de balance des paiements. Je suis soulagé de voir certains signes que les augmentations de salaires commencent à réagir à la situation économique.

J'estime qu'il est extrêmement important que les Canadiens voient les difficultés économiques auxquelles est confronté actuellement le pays dans une perspective très large, car cela les aidera à adopter des attitudes qui atténueront les privations économiques actuelles. Le Canada n'est pas le seul pays qui soit en proie à des difficultés économiques. En effet, l'économie mondiale est en train d'effectuer une transition beaucoup plus fondamentale que toutes celles qu'elle a effectuées depuis la période de reconstruction économique qui a suivi la fin de la Seconde Guerre mondiale. La conjoncture actuelle présente de nombreuses analogies avec les récessions cycliques des trente dernières années, mais elle s'en distingue aussi de façon marquée. L'une des principales différences, c'est que l'inflation mondiale a pris tant d'ampleur au cours des années 70 que la confiance dans la valeur future de la monnaie est à présent gravement entamée dans la plupart des pays. C'est pour cette raison qu'il n'est plus possible d'appliquer le type de politiques financières expansionnistes que les gouvernements et les

banques centrales avaient adoptées pour stimuler leurs économies au cours des récessions précédentes. Cette recette n'est plus efficace, car les événements ont prouvé - et des observateurs objectifs le reconnaissent - qu'elle engendre l'inflation et non la prospérité. Voilà pourquoi presque tous les gouvernements et toutes les banques centrales du monde libre ont fait preuve, et continuent de faire preuve, de beaucoup plus de modération qu'ils ne l'auraient fait autrement. Ils en sont venus à la conclusion que, pour assurer la prospérité économique, il faut repousser la menace de l'inflation. Pour assurer la prospérité économique, il faut restaurer la confiance dans la valeur de la monnaie.

Voilà ce qui se passe aujourd'hui dans le monde des échanges internationaux. Le Canada participe à ces échanges, et sa prospérité a dépendu par le passé - et dépendra à l'avenir - de sa capacité de concurrencer efficacement ses partenaires. Et cela, nous ne pourrons le faire que si nous commençons par effectuer les ajustements qui doivent permettre à l'économie canadienne d'atteindre des niveaux élevés de production sans qu'il n'y ait d'inflation, ce dont elle était habituellement capable.

Je sais bien qu'il n'y a, dans mes propos, rien qui puisse atténuer dans l'immédiat les tensions et les souffrances qu'endurent tant de gens au pays. Je suis au courant de cette situation et je la déplore. Mais plus on s'opposera à la

pression croissante qui s'exerce dans le monde en faveur d'une amélioration de la productivité et d'un ralentissement de la progression des coûts, plus la période d'ajustement sera longue, douloureuse et pénible.

Mais les choses ne doivent pas forcément se passer ainsi. Les Canadiens peuvent, dans leur propre intérêt, réagir aux difficultés économiques actuelles en contrôlant les coûts et en faisant baisser le taux d'inflation. Ils sont capables de sortir de cette phase difficile de transition plus rapidement et de préparer la voie à une reprise économique plus prompte et plus vigoureuse.

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RECOVERING FROM INFLATION

NOTES FOR REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE CANADIAN CLUB
TORONTO, ONTARIO
NOVEMBER 29, 1982

Notes for remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to The Canadian Club
Toronto, Ontario
November 29, 1982

RECOVERING FROM INFLATION

The Canadian economy like so many others around the world is passing through a very difficult time. The economic weakness that we are now experiencing is much worse than at any other time in the post-war period. In my remarks today I want to try to put our present situation into perspective. If the major source of our current difficulties is clearly recognized we will stand a better chance of a good economic performance in the future.

The major source of our current difficulties is inflation. A lot of inflation. It is what Theodore H. White has called "The Great Inflation". I think that term is warranted.

Let me encourage you to see current economic developments in historical perspective by reminding you of the broad sweep of events over the last half century. First came the Great Depression of the 1930s, and then the Second Great War, 1939 to 1945. Then came what can be called the Great Post-War Prosperity, from 1946 to about 1970. It was perhaps

the best quarter century in world history in terms of advances in living standards. Unemployment in Canada was generally low. For much of the period inflation was held in check. This was made easier by the fact that strong expectations of inflation were slow to develop owing in large part, I believe, to recollections of the Great Depression and fear of a return to that condition. But that fear gradually faded as it became increasingly apparent where the biases of post-war economic policies lay. Each successive cycle in economic activity was marked by a higher average rate of cost and price increases. Attitudes gradually shifted, and the development of a generalized inflationary psychology was well under way by the end of the period.

This brings me to the Great Inflation. I do not intend to spend time today going over its origins and history in any detail. I have done that on other occasions. Fundamentally it was caused by over-ambitious economic policies in general, and financial policies in particular. Nearly all countries drove their economic systems too hard, harder than they were capable of performing without generating inflationary pressure.

It is worth noting that the world supply shocks of the 1970s, of which the change in the energy situation was the most dramatic, were not prime causes of the major upsurge in inflation of the early 1970s; it was well under way before the first increase in oil prices. Energy costs made the situation much more difficult to handle in all countries, but

many of those most exposed to the oil shocks nevertheless managed to achieve the greatest success in restraining inflation.

During the 1970s the countries that accommodated inflation did not enjoy better economic performance than those that resisted it. Far from it. Lack of firmness in financial policies only reinforced inflation and expectations of inflation. The tough decisions that could have been taken earlier had then to be taken in a more exposed position. By the late 1970s countries throughout the industrial world had nearly all come to see inflation as the main threat to satisfactory economic performance, and were practicing financial restraint.

Policies of financial restraint, in particular monetary restraint, have been bringing inflation back under control. The mix of fiscal and monetary policies around the world could have been improved upon. In many countries the load of restraining inflation was put more on monetary policy than on fiscal policy, and this led to extraordinarily high interest rates and to a very uneven impact of restraint on different groups in the societies. A more balanced approach would have been better. Earlier implementation of firmer financial restraint would also have been better. The mild restraint that was applied in the earlier years was unable to cope with the momentum of inflation and inflationary expectations, and it was only after the degree of restraint had become very strong indeed that progress against inflation began to be made.

We are now experiencing the clash between the powerful momentum of inflation and financial restraint strong enough to curb it. The fact that all major countries have been pursuing anti-inflationary goals has meant that domestic restraint has been reinforced by a global effect.

The strains to which we in Canada are now subject have been much intensified by resistance to the anti-inflationary process. Whether due to the persistence of expectations of high inflation or to rigidities in our economic systems, the trend of salaries and wages has responded much less flexibly to the developing situation than was desirable. There are now, however, some signs that more and more people are responding in their own interests to the weak market situation.

The result of all this is that a reduction of the rate of inflation in Canada has been accompanied by a severe decline in economic activity. The strains are distressingly obvious: high unemployment, a lot of idle plant capacity, low business profits and many business failures. More than anything else this outcome is the result of having allowed inflation to get so far out of hand. How much better it would have been to have avoided inflation in the first place!

When one thinks of the dimensions of the Great Inflation it is natural to think in terms of the magnitude of the increase in prices or of the decline in the value of money. Thus over the past decade the purchasing power of a dollar in Canada dropped by over 60 per cent, or

by more than over the preceding twenty-five years. But as a description of what happened in our economy that is only the tip of the iceberg. There was also the extent to which confidence in the future value of money was dissipated and the effect of this on economic planning. There was the turmoil, the uncertainties and the frustrations that ensued from volatile interest rates and from the sharp changes in exchange rates that reflected swings in views as to where countries were headed. There was the pervasive erosion of people's confidence in the performance of the economic system and in its basic fairness.

One of the ways that growing expectations of inflation shaped attitudes in Canada and elsewhere was the increasing acceptance of the notion that the sure way to success was to take on increasing amounts of debt. This was, in effect, betting that the immediate burden of indebtedness would be written down by inflation in fairly short order, leaving the borrower ahead of the game. Thus prudent behaviour became devalued. And this of course was the way it worked for quite some time, on a national and an international scale. In the process borrowers, consciously or otherwise, acquired a vested interest in the continuation of high inflation. And if the rate of inflation took another surge, so much the better.

The recent <u>Report of the Ministerial Advisory Committee on Inflation and the Taxation of Personal Investment Income</u> -- The Lortie Committee -- accords with the observations that I have just made. The Committee agreed that the interaction of inflation and the taxation system,

coupled with conventional accounting concepts, had a significantly adverse effect on both the level and the allocation of savings and investment. The members of the Committee all agreed that the best long-term solution was to greatly reduce or eliminate inflation. They recommended unanimously that governments in Canada, as well as all other sectors, exert every effort to reduce or eliminate inflation.

As a result of the distortions that have taken place, the process of withdrawal from a world of inflation was bound to create difficult transitional problems in financial markets. Overly large debt positions acquired in an inflationary climate constitute one such problem. The need to deal with this overhang of debt will act as a drag on expansion for some time to come. One mitigating element is the fact that in recent years so much debt, even medium- to long-term, has been taken up on a floating rate basis -- that is to say at interest rates that are linked to those on short-term obligations. The level of shorter term rates declines as inflation is lowered. This is now providing a welcome measure of relief to the burden of debt service.

The indebtedness problem has a major international dimension. A number of countries that built up huge debts during the inflationary period now find their ability to service those debts greatly hampered by weak world markets for their exports. Borrowing clearly cannot go on as before, but there is a need to ensure that sound financing does not dry up completely as lenders tilt their attitudes and policies in a more cautious direction. An international community of interest is involved,

with a major and increasing role to be played by international financial institutions in seeing the adjustment through with a minimum of disruption to world trade and payments. This will involve a great deal of international co-operation, which must and will be forthcoming.

I come back now to our current situation. There are not many bright spots in it but one fundamental change for the better is the progress that has been made in reducing the rate of inflation. As a result scope has become available for a reduction of interest rates, and a major downward adjustment has occurred. For example, since mid-year the prime lending rate of the chartered banks has fallen from 18 1/4 per cent to 13 per cent. These developments were of course greatly helped by the steep decline in interest rates in the United States.

Now that I have come to the subject of monetary policy I should note that for some time the Bank of Canada has been unable to make much use of monetary aggregate targets in the conduct of policy. If you will bear with me I will try to make a brief explanation of this rather technical matter.

Beginning in 1975 the Bank adopted an explicit monetary aggregate target. It had come to the view that targetting on the narrowly-defined monetary aggregate, M1, would help it to make the right judgments about interest rates in inflationary times. I believe this practice did improve monetary policy. The use of a monetary target also helped to clarify what was meant by monetary restraint.

Unfortunately, the monetary aggregate to which the Bank of Canada has been paying most attention, currency and demand deposits or M1, has for some time -- more than a year -- been a less reliable guide than it was earlier. On a number of previous occasions the Bank has made reference to the instability that has emerged in the relationship between M1 and levels of spending and interest rates. It is now clear that there have been major and continuing shifts out of M1 as a result of changes in banking practices. These practices include the continuing expansion of cash management facilities to businesses which permit overnight investment of surplus current account balances, and the increasing availability and use of new personal accounts that combine both chequing and saving features. As a result the recorded M1 series is not a useful guide to policy at the present time. In these circumstances I want to make it known that the Bank no longer has a target range for it. I regret this development because a monetary aggregate that is in fact systematically related to the trend of total spending is helpful in judging the appropriate degree of monetary expansion, and particularly in avoiding cumulative error. Thus the Bank is continuing to search for ways for making more use of a monetary aggregate than it can at the present time.

What I have stated here about monetary aggregates will not be news to those who have been following closely Bank actions and reading our statements in recent months. They will also be aware that the absence of a usable monetary target has not been a critical matter in the recent period. Relevant evidence from economic and financial developments

has certainly not been lacking. In the current economic environment the Bank has very much wanted to see interest rates as low as would be consistent with continuing resistance to inflation. It rejected the idea of deliberately attempting to force interest rates down quickly by several percentage points, regardless of the impact on the exchange rate, because this would contribute to loss of confidence in the Canadian dollar, and this, together with the inflation that would ensue, would make it impossible to sustain the lower level of interest rates. I believe that our approach has been realistic and forward-looking, and I am pleased that it has facilitated a major downward adjustment in interest rates in recent months. I believe that our approach offers the best prospect of further progress in achieving lower interest rates, although even if things go well it is not reasonable to expect an uninterrupted downward trend -- markets do not operate that way.

Our interest rates are now not far above those of the United States, where the inflation rate is much lower than here. Further progress in getting interest rates down in Canada depends more than anything else on getting our inflation rate down further.

As a result of the progress that has been made in turning back inflation in Canada we can talk more confidently about a trend of price increase expressed in single digits rather than double digits. However, that is well short of reasonable price stability. What is more, our main trading partners are a good deal closer to that goal than we are. So the progress we have made to a better price and cost performance

needs to be continued. The more rapid that progress, the better will be our prospects for a resumption of real growth.

I do not believe that many of you would disagree with that view but some commentators imply that the time has come to forget about the problem of inflation and concern ourselves only with expansionary policies. This advice rests on the most popular and most serious misunderstanding about economic policy that there is -- namely, that governments and central banks can achieve and maintain high employment if they are prepared to stop worrying about inflation. No economic advice is more seductive, none is easier to follow for a time, none has been tried more often and none has failed more completely. The fact is that a high degree of monetary stability is an essential condition for -- not an obstacle to -- sustained high employment. That is why it is wise to end the Great Inflation.

In concluding, I want to pull together some of the thoughts I have expressed today. The major source of our recent serious economic difficulties is the inflation that we have been through. Success in bringing inflation down is essential if we are to get out of these difficulties. We can take heart from the slowing in inflation that has taken place already in Canada, and from the further progress in prospect. In these circumstances, the trend of interest rates has been down. As we further rid ourselves of the burden of inflation, lower interest rates can play a key role in the economic recovery we all want so badly.

Statement prepared for the appearance of

Gerald K. Bouey

Governor of the Bank of Canada

before the

Standing Senate Committee on National Finance

Wednesday, December 8th, 1982

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Governor of the Bank of Canada
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A statement that I made in a speech last week to the effect that the Bank of Canada no longer has a target for the M1 definition of the money supply has given rise to a variety of reactions. Some people seem to think that I was announcing a change in the thrust of monetary policy. Others, who have followed our actions and statements in recent months and years more closely, recognized that no departure from the path we had been following was being signalled. In the light of these different reactions I am pleased to have this opportunity to talk to you about monetary policy and to clear up any confusion that may exist.

In explaining monetary policy it often helps to begin with its basic objectives. The principal objective of the Bank is to achieve a pace of monetary expansion that best serves the needs of the Canadian people. Experience has proven, I believe, that the rate of monetary expansion required for this purpose is one that is consistent with reasonable price stability. Since an immediate return to price stability is not practical in a country where inflation and expectations of inflation have become as ingrained as they have in Canada, the principal objective for monetary policy in current conditions should be to help the economy move toward

reasonable price stability. This, in turn, will help us to achieve the lower levels of interest rates we need for economic recovery.

This brings me to interest rates. Monetary policy has its effect on the economy, on output and prices, through its effect on interest rates. It affects interest rates by altering the rate of monetary expansion. The determination of interest rates in our economy is a market process that reflects the borrowing and lending activities of all participants -- government entities, businesses and individuals, residents and foreigners. The Bank of Canada participates in that market process and it can influence the interest rates that the market produces by expanding or contracting central bank money. The extent of its influence is subject to important practical limitations that I will not go into here. The point I wish to make here is that the policy question for the Bank of Canada from day-to-day and over time is what use of the power to influence interest rates by monetary expansion best promotes the national economic interest.

That is not a simple question, and there is no easy way to find the answer. What one has to do is to examine the whole complex economic process sufficiently carefully to come to a balanced view about how the economy would respond over time to different rates of monetary expansion.

That is what the Bank of Canada has always tried to do, and that is what it continues to try to do. To that end it has a considerable staff of able and experienced economic analysts who are occupied constantly

in observing developments in the economy and the international environment, and who use all the information and all the analytic techniques that are available to throw what light they can on why the economy is performing as it is. In this process it is natural that central banks look for stable relationships between measures of the money supply and more general indications of economic performance to help them in their analyses. Such relationships encourage the central bank to assess monetary policy within a longer run framework.

For a number of years there was a relatively stable relationship between the narrowly-defined money supply -- currency and demand deposits (M1), essentially the transaction balances in the economy -- and interest rates and the trend of total spending in the economy. So long as that relationship existed it was helpful both to making and to explaining monetary policy, and the Bank of Canada used it as a basis for its monetary targets and gave a good deal of prominence to it. The Bank was, however, aware from the beginning that events might undermine the stability of that relationship. As I said in my Annual Report for 1975:

> "It should be borne in mind that M1 will provide useful information for policy purposes only so long as the public's behaviour with respect to its holdings of transactions balances per dollar of income continues to follow a reasonably predictable pattern. It is possible that the public's habits in this regard will change over time, perhaps in response to innovations in payments technology and in the characteristics of the various kinds of financial instruments offered by deposit-taking institutions and their close competitors. The Bank of Canada recognizes the need for careful monitoring of such developments and of their impact on the public's behaviour".

During the period that the Bank of Canada had a monetary target for M1 it continued to do the same kind of analysis of developments as it would have done without the target in order to check the signals that it was getting from M1. The M1 target system was never regarded by us as an automatic pilot. For more than a year now we have been aware that the M1 target system that existed was not giving good direction signals and we have not been guided by it.

The reasons why the M1 target system ceased to be a good guide are clear enough. As I pointed out in my speech on November 29th, a number of important recent innovations in banking services have caused major and continuing shifts of the money balances held by individuals and businesses for making payments out of the demand deposit accounts that are included in M1. These innovations include the much more widespread availability to businesses of the cash management facilities provided by banks. These facilities permit all the demand deposit balances that may be held by a business across the country to be consolidated at the end of the day and the surplus transferred into an overnight investment account. As for individuals, an increasing number of them are giving up their personal chequing accounts and are instead making use of recently introduced deposit accounts which provide chequing services and pay a competitive savings interest rate when a certain minimum balance is held in the account.

The difficulties we have encountered in making use of M1 are well known to those who follow monetary policy matters reasonably closely.

My Annual Report for 1981 contained a description of the problems. Our difficulties were serious enough at the time of writing that Report last winter that I said that for the time being we were "not inclined to draw inferences about monetary conditions from the recent pattern of M1 growth beyond those which can be confirmed by other economic and financial indicators". When giving my assessment of monetary targetting in the 1982 Per Jacobsson Lecture in September I summarized our problems with M1 once again and concluded with a great deal of regret that our M1 target had not been able to provide the clear-cut guidance for monetary policy that one had hoped for.

We delayed announcing that we were dropping our target for M1 because of the possibility that we might be able to adjust the target to take adequate account of the shifts and thus preserve the usefulness of M1 as a policy guide. We have done this before but the size and ongoing nature of the current shifts have made such an adjustment impossible. I wish to stress, however, that we have dropped the target solely for these technical reasons -- not because we have changed our minds about the desirability in principle of money supply targets. We are therefore continuing to explore that use of monetary aggregates.

Perhaps I can give you a more specific indication of how monetary policy has been determined for some time now without any help from a monetary target. Adequate relevant information needed for monetary policy decisions has certainly not been lacking. We know how weak the economy is. We know that we want to see interest rates as low

as would be consistent with continuing resistance to inflation. We believe that we will make the most progress in moving to lower interest rates if we do not use monetary expansion in a way that will rekindle expectations of higher inflation and upset reasonable confidence in the exchange value of the Canadian dollar. With this approach we have been able to facilitate a major downward adjustment in interest rates in recent months.

In current circumstances the major guide to monetary policy must be the degree of progress the Canadian economy is making in getting inflation down. Our goal is sustained economic recovery. As I said in my speech last week: as we further rid ourselves of the burden of inflation, lower interest rates can play a key role in the economic recovery we all want so badly.